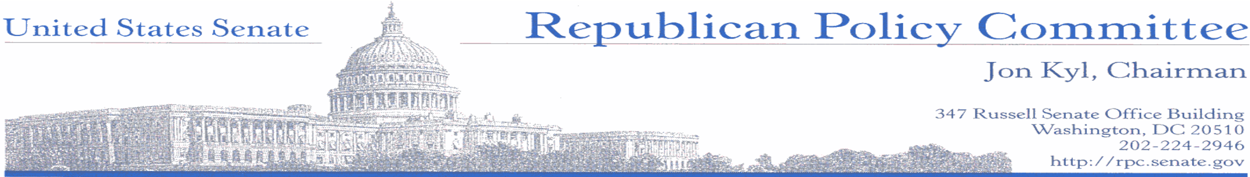


February 28, 2005

***A Broader Perspective on Social Security Reform***

# Retirement-Income Security: The Role of Personal Savings


### *Executive Summary*

- With Social Security reform as a top priority, President Bush opened a debate on a critical aspect of a much broader issue – ensuring that Americans have adequate income for their retirement.
- At its inception, Social Security was viewed as one leg of a "three-legged stool," with personal savings and pension benefits making up the vast majority of retirement income. Today, Social Security is the primary source of retirement income for two-thirds of the program's beneficiaries.
- The most direct way for Americans to influence their retirement-income security is through personal savings. Nevertheless, the personal-savings rate in this country has fallen to the lowest level since before the Social Security Act was signed into law.
- Congress has enacted important savings incentives and reduced tax rates on capital investments to create a favorable economic environment to facilitate personal savings. If these initiatives are to reach their full potential, however, they cannot be allowed to expire.
  - ➢ *2001 tax bill* – The increased contribution limitations for tax-deferred savings accounts and "catch-up" contributions for older workers have made tax-deferred savings even more attractive. In 2003, Individual Retirement Accounts (IRAs) held $2.9 trillion in assets and 401(k) plans represented $1.9 trillion.
  - ➢ *2003 tax bill* – In the year following its enactment, corporate dividend distributions by S&P 500 companies increased by $26 billion, benefitting all individuals who invest their savings in dividend-paying stocks. Additionally, in 2008, the dividend and capital-gains rates for low-income taxpayers will drop to zero, providing an even greater savings incentive.
- To save for retirement successfully, Americans will need to improve their financial literacy. While many large companies already provide significant financial-information resources, Congress should take steps to encourage more businesses to provide their employees with greater financial education and access to personal investment advice.

# Introduction

By embracing Social Security reform as a top priority, President Bush opened a debate on a critical aspect of a much broader issue facing this country – ensuring that Americans have adequate income for their retirement.[1]

When the Social Security program was established in 1935, President Roosevelt stressed that the program was intended to be a safety net to protect seniors "against poverty-ridden old age."[2] It was also a benefit that few were expected to receive since the life expectancy for seniors at that time was well below the 65-years-of-age necessary to qualify for Social Security benefits.[3] Accordingly, Social Security at its inception was viewed as one leg of a "three-legged stool," with personal savings and pension benefits making up the vast majority of an individual's income in retirement.[4]

Despite its original intent, Social Security has become the primary source of retirement income for two-thirds of Social Security beneficiaries.[5] By neglecting the other two legs of the stool, individuals relying on Social Security are effectively planning for subsistence-level income on which to live out their retirement years. With a long history of Americans raising their standard of living, Congress should encourage individuals to strive to maintain a retirement standard of living similar to the one they enjoyed while in the workforce.

Ensuring the permanent sustainability of the Social Security system so that it can provide protection from poverty in retirement is a necessary objective. But in the larger context of ensuring income security for Americans in retirement, it is not sufficient. Congress has the opportunity to encourage Americans to strive for a higher quality of retirement life by addressing the issue of retirement-income security in a comprehensive manner. Based on the Roosevelt-era analogy of the three-legged stool, that effort should include reform of Social Security, but also measures to encourage personal savings and strengthen the pension system.

This paper – the first in a series – addresses personal savings, and it considers options for helping Americans save more for their retirement. Subsequent papers will address the other aspects of retirement-income security.

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[1] President George W. Bush, Report on the State of the Union Delivered to a Joint Session of Congress, February 2, 2005, *Congressional Record*, page S878.

[2] Statement of President Franklin D. Roosevelt upon signing the Social Security Act, August 14, 1935.

[3] Center for Disease Control and Prevention, "Estimated Life Expectancy at Birth," National Vital Statistics Reports, Volume 53, Number 6, November 10, 2004.

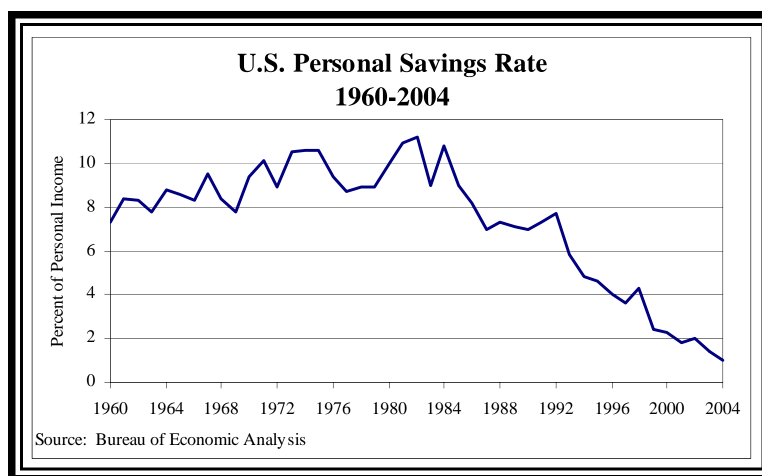
[4] Social Security Administration (SSA), "Research Note #1: Origins of the Three-Legged Stool Metaphor for Social Security" – http://www.ssa.gov/history/historianoffice.html.

[5] SSA, "Income of the Aged Chartbook, 2001," April 2003, p. 4 – http://www.ssa.gov/policy/docs/chartbooks/income_aged/2001/iac01.pdf. SSA estimates that Social Security benefits provide 50 percent or more of total income for 65 percent of the beneficiaries, 90 percent or more of income for one-third of the beneficiaries, and are the only source of income for 20 percent of beneficiaries.

## The Role of Personal Savings In Retirement-Income Security

At its most fundamental level, retirement-income security is the responsibility of all Americans, which they can directly influence through personal savings during their working years. As Figure 1 below illustrates, however, the personal-savings rate in the United States has seen a dramatic decline over the last two decades, reaching 1 percent of personal income in 2004 – the lowest rate since the year before the Social Security system was created.[6]

**Figure 1**



Source: Bureau of Economic Analysis

The nation's low personal-savings rate is primarily the result of Americans' tendency to consume rather than save their income. As a member of the President's Advisory Panel on Federal Tax Reform recently noted, "We are the engine of growth globally, but we also have become very much a consumption economy versus the rest of the world, which is more of [a] savings economy."[7] However, the growing perception among Americans that Social Security benefits will replace a significant percentage of their pre-retirement income may well have contributed to the steep decline since the 1983 Social Security legislation.[8]

Broadly speaking, the country's low personal-savings rate puts pressure on the economy by reducing the capital available for future consumption and investment, which in turn restrains future economic growth. On a more personal level, however, low personal savings reflects the insufficient accumulation of assets to support current and future retirees.

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[6]Bureau of Economic Research (BEA), National Income and Product Accounts, Table 2.1, Personal Income and Its Disposition, January 28, 2005 – http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N#S2. Some economists argue that the BEA's personal-savings rate understates actual savings because it does not reflect increased cash flows resulting from gains on equities, houses, and mortgage refinancings. See David Malpass and Sandy Batten, "Personal Savings Rate Understates Savings," Bear Stearns Global Commentary, May 20, 2004. Even from this perspective, however, the nation's savings rate has still declined since the early 1980s.

[7]Liz Ann Sonders, Chief Investment Strategist at Charles Schwab quoted by *Dow Jones Newswires*, February 16, 2005.

[8]Social Security Amendments of 1983, Public Law 98-21, April 20, 1983. This legislation was the last major reform of the Social Security program and was intended to provide financial solvency for the program for 75 years.

While the current efforts to reform the Social Security program, including the creation of personal accounts, are expected to have positive effects on the personal-savings rate,[9] Congress should encourage Americans to save for retirement through tax-deferred arrangements such as IRAs and defined-contribution plans as well as through after-tax savings in traditional bank and brokerage accounts.

## ***2001 Retirement-Savings Improvements***

The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 tax bill)[10] included provisions to protect pension-plan participants and simplifications of the tax law to encourage businesses to offer and maintain retirement-savings plans. In addition, it significantly changed the tax rules governing pensions and individual retirement arrangements to encourage retirement savings. Nevertheless, the 10-year life span of that legislation creates a disincentive for businesses to offer retirement-savings opportunities and for individuals to save for their retirement because there is no certainty with respect to the tax rules governing tax-deferred retirement accounts. Congress should eliminate that disincentive by making the 2001 tax bill permanent. In particular, special attention must be given to three aspects of that legislation, all of which hold significant potential for increasing personal savings.

**Increased Contribution Limitations**: As illustrated in Figure 2 below, the 2001 tax bill gradually increased the maximum amount that individuals may contribute to the various types of tax-deferred retirement accounts. Moreover, for the first time in the history of IRAs, the 2001 tax bill requires that the Treasury Department adjust the contribution limit for inflation beginning in 2008.

**Figure 2**

**Increases in the Contribution Limitations from the 2001 Tax Bill**

| Tax-Deferred Retirement Account | Pre-2001 Tax Bill Contribution Limit | New Phased-in Contribution Limit |
|---|---|---|
| IRAs | $ 2,000 | $ 5,000 (2008) (indexed for inflation 2009-2010) |
| SIMPLE Plans | $ 6,500 | $ 10,000 (2005) (indexed for inflation 2006-2010) |
| 401(k) Plans | $ 10,500 | $ 15,000 (2006) (indexed for inflation 2007-2010) |

Source: 2001 tax bill §§ 601 and 611.

[9]Congressional Budget Office (CBO), "Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," July 21, 2004 – http://www.cbo.gov/ftpdocs/56xx/doc5666/07-21-CraigLetterUpdated.pdf.

[10]H.R. 1836, 107th Congress, 1st Session, Public Law 107-16, June 7, 2001.

In addition to enhancing the incentive for individuals to save more in their tax-deferred retirement accounts,[11] a key rationale for these changes was to encourage small business owners to start defined-contribution plans for their employees. Many entrepreneurs neglect to save for their own retirement during the early years of their business so they can reinvest their earnings to expand their operation.[12] By increasing the ability of small business owners to save for their retirements, in large measure through increased contribution limits, the 2001 tax bill was expected to increase the prevalence of small business retirement plans and coverage of employees. Anecdotal evidence indicates that the legislation is achieving that goal. Survey results show a 5.9-percent increase between 2000 and 2003 in the number of participants in retirement plans sponsored by companies with 100 or fewer employees – typically defined-contribution plans.[13]

If the 2001 tax bill is allowed to expire, a dramatic decline in the contribution limits will occur – up to an 18.8-percent decline in permissible employee contributions to 401(k) plans and up to a 60-percent decline for IRAs. As Figure 3 illustrates, the reduced contribution limits will eliminate $3,000 in savings potential for the various tax-deferred retirement savings accounts. Investing that $3,000 at the start of each of the next 20 years would produce additional retirement savings of $104,158, assuming a 5-percent average annual rate of return.

**Figure 3**

**Effects of the Expiration of the 2001 Tax Bill on Contribution Limitations**

| Tax-Deferred Retirement Account | Estimated 2010 Contribution Limit | Estimated 2011 Contribution Limit | Percentage Decline |
|---|---|---|---|
| IRAs | $ 5,000 | $ 2,000 | 60.0 |
| SIMPLE Plans | $11,000 | $ 8,000 | 27.3 |
| 401(k) Plans | $16,000 | $13,000 | 18.8 |

Source: Internal Revenue Service.
Note: The 2010 contribution limits reflect the increases enacted in the 2001 tax bill adjusted for inflation based on Congressional Budget Office estimates. The 2011 contribution limits, except for IRAs, are based on the pre-2001 limits adjusted for inflation. Prior to the 2001 tax bill, IRAs were not indexed for inflation.

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[11]For individuals, an IRA or employer's 401(k) plan is attractive because they are permitted to deduct allowable contributions from their taxable income (subject to certain income and contribution limits), which reduces the after-tax cost of a contribution. For example, if an individual in the 28-percent tax bracket contributes $4,000 to his IRA account in 2005, it will actually cost him only $2,880 because they save $1,120 in taxes. See James M. Poterba, "Savings for Retirement: Taxes Matter," *Issue in Brief*, No. 17, Center for Retirement Research, May 2004 – http://www.bc.edu/centers/crr/issues/ib_17.pdf – "Even though an individual with a traditional IRA owes deferred income tax on the principal in the account, over long time periods the benefits of accumulating assets at the before-tax rather than after-tax rate of return permits the IRA to deliver more retirement wealth than the taxable account."

[12]Sharon A. DeVaney and Sophia T. Chiremba, "Comparing the Retirement Savings of the Baby Boomers and Other Cohorts," Compensation and Working Conditions Outline, U.S. Department of Labor, Bureau of Labor Statistics (BLS), January 24, 2005 – http://www.bls.gov/opub/cwc/cm20050114ar01p1.htm.

[13]Employee Benefit Research Institute (EBRI) estimates from the 1988–2004 March Current Population Surveys.

The positive effects of tax-deferred retirement accounts are well established – in 2003, IRA accounts held $2.9 trillion in assets and 401(k) plans represented $1.9 trillion.[14] While the contributions limits have gradually increased since 2001, the full measure of their effectiveness is likely to have been constrained by external events such as the 2001 terrorist attacks, the recession and slow recovery, and the War on Terror, which discourage long-term savings in favor of having cash on hand. For these incentives to reach their maximum potential and to avoid creating a disincentive for savings, Congress must not allow the increased contribution limits to expire at the end of 2010.

**"Catch-Up" Contributions**: The 2001 tax bill also permitted older persons to make additional contributions to tax-deferred retirement accounts in excess of the individual contribution limits. These "catch-up" contributions were intended to encourage individuals age 50 or older, many of whom took time off during their careers to raise a family or start a small business, to make up for lost savings.

When coupled with the increased contribution limits discussed above, catch-up contributions give Americans approaching retirement a valuable tool to make up for lost time.[15] Available data indicate that 90 percent of 401(k) plans now offer catch-up contributions to their employees, and their use by older workers should increase as they are fully phased in by 2006, and knowledge of their availability becomes more widespread.[16]

For an individual who turns 50 in 2005, the ability to make catch-up contributions holds significant potential to make up for lower savings rates in earlier years. As Figure 4 illustrates, if

**Figure 4**

**Benefits of Catch-Up Contributions for a 50-Year-Old Saving to Age 65**

| | IRA | SIMPLE Plan | 401(k) Plan |
|---|---|---|---|
| Catch-Up Contributions (Plus 5-Percent Earnings) | $ 22,618 | $ 61,505 | $ 126,923 |
| Retirement Savings in Jeopardy if Catch-Up Contributions Expire at the End of 2010 | 12,578 | 34,846 | 73,604 |

Note: Calculations based on fully phased in catch-up contribution levels adjusted for inflation through 2020, with earnings compounded at an annual 5-percent rate of return.

[14] Federal Reserve, "Flow of Funds Accounts of the United States, Flows and Outstandings, Third Quarter 2004," December 9, 2004, Table L.225.i – http://www.federalreserve.gov/releases/Z1/Current/z1.pdf; Sarah Holden and Jack VanDerhei, "401(k) Plan Asset Allocation, Account Balances, and Loan Activities in 2003," EBRI Issue Brief No. 272, August 2004 – http://www.ebri.org/ibpdfs/0804ib.pdf.

[15] A 2001 study found that older individuals are significantly constrained by contribution limitations when they endeavor to save more in their later working years. Jagadeesh Gokhale, Laurence J. Kotlikoff, and Mark J. Warshawsky, "Life-Cycle Savings, Limits on Contributions to DC Pension Plans, and Lifetime Tax Benefits," National Bureau of Economic Research (NBER), Working Paper 8170, March 2001, p. 22 – http://papers.nber.org/papers/w8170.pdf.

[16] Gary Peterson, "Play Catch-up With EGTRRA," *Credit Union Magazine,* January 2005.

this option were made permanent, today's 50-year-olds would be able to save an additional $126,923 in their 401(k) plans by the time they reach 65, assuming a 5-percent rate of return. In contrast, the expiration of catch-up contributions after 2010 would cost these individuals $73,604 in potential contributions and tax-deferred earnings – a consequence that Congress should work to avoid.

**Portability of Retirement Savings**: With estimates showing that some individuals will hold as many as 10 jobs during their working lives,[17] an employee may be discouraged from participation in the employer's retirement plan if it is too difficult to transfer the accumulated savings when the employee takes a new job. In addition, for a worker who has to keep track of multiple accounts with prior employers until retirement, there are added risks with respect to his ability to manage multiple accounts effectively as well as potential forfeiture of the savings if he loses track of an account.

The 2001 tax bill addressed this problem by substantially modifying restrictions on the rollover of various types of tax-deferred savings accounts to an individual IRA or another employer-sponsored plan. These provisions remain in force through 2010, but as that date approaches and employees grow concerned that portability of their retirement savings will be more restrictive, they will again be less likely to participate in employer-sponsored plans. To avoid that result, Congress must make the portability provisions permanent as soon as possible.

### *2003 Dividend and Capital-Gains Rate Reductions*

Complementing the structural changes to retirement-savings accounts in the 2001 tax bill, two provisions in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 tax bill)[18] dramatically improved the economic environment for personal savings. Specifically, the 2003 tax bill reduced the tax rate applicable to dividends and capital gains received by individual taxpayers to 15 percent (and to 5 percent for taxpayers in the lowest two tax brackets).[19] Prior to that legislation, dividends were taxed at a taxpayer's marginal income-tax rate, which in 2002 could be as high as 38.6 percent, and capital gains were taxed at 20 percent (10 percent for individuals in the lowest tax bracket).

These improvements in the nation's tax policy have resulted in far-reaching benefits for millions of American households. For example, the reduction in the dividend-tax rate prompted a $26-billion increase in regular dividends paid by S&P 500 companies in the year following the

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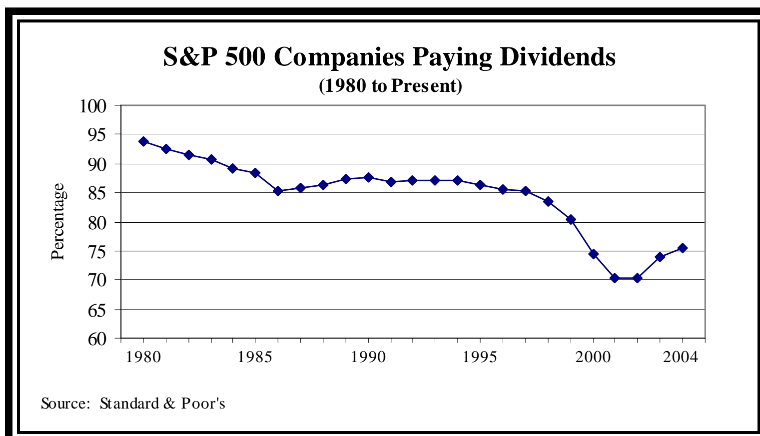
[17]The BLS estimates that younger baby boomers (those born between 1957 and 1964) held an average of 10.2 jobs before reaching age 38. BLS, "Number of Jobs Held, Labor Market Activity, and Earnings Growth Among Younger Baby Boomers: Recent Results from a Longitudinal Survey," USDL 04-1678, August 25, 2004, Table 1 – http://www.bls.gov/news.release/pdf/nlsoy.pdf.

[18]H.R. 2, 108th Congress, 2d Session, Public Law 108-27, May 28, 2003.

[19]Jobs and Growth Tax Relief Reconciliation Act §§ 301 and 302. For a complete discussion of the benefits resulting from the lower tax on dividends, see the RPC's policy paper, "The Dividend-Tax Cut: A Success Story with More Potential," October 4, 2004 – http://rpc.senate.gov/_files/Oct0404DividendTaxMW.pdf.

enactment of the 2003 tax bill.[20] As Figure 5 illustrates, the increase in regular dividend payments has also reversed a trend of declining dividend distributions among S&P 500 companies over the past decade. Moreover, in the year following enactment of the lower dividend-tax rate, 113 publicly traded corporations *initiated* dividend payments for the first time, compared to an average of 22 companies in prior years.[21]

**Figure 5**




The increase in dividends translates into benefits to *all* taxpayers who invest in dividend-paying stocks. With an estimated 79 percent of equity investors participating in tax-deferred retirement plans,[22] the increase in corporate dividends results in additional contributions to their accounts, which can then compound tax-free until they are withdrawn in retirement.[23]

In addition, to the extent that rising dividends result in increased stock prices,[24] shareholders receive an added benefit. As a stock's price increases, investors realize larger capital gains when they choose to sell the equity investment, again regardless of whether it is held in a taxable or tax-deferred account.[25] For Americans saving through taxable accounts, capital gains are now taxed at a lower, 15-percent tax rate.

While opponents have argued that the reduction of the dividend and capital-gains tax rates only benefits the "rich," they overlook a critical feature of the 2003 tax bill that directly benefits lower-income Americans. Starting in 2003, the dividend and capital-gains rates for

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[20]Stephen Moore and Phil Kerpen, "Show Me the Money! Dividend Payouts after the Bush Tax Cuts," Cato Institute, October 11, 2004 – http://www.cato.org/pubs/briefs/bp-088es.html.

[21]Raj Chetty and Emmanuel Saez, "Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut," NBER Working Paper 10572, June 2004, p. 3 – http://papers.nber.org/papers/w10572.pdf.

[22]"Equity Ownership in America, 2002," Investment Company Institute and Securities Industry Association, p. 19 – http://www.sia.com/research/pdf/equity_owners02.pdf.

[23]Joint Economic Committee (JEC), "Who Benefits from Ending the Double Taxation of Dividends?" February 2003, p. 7 – http://jec.senate.gov/_files/DividendDoubleTax.pdf.

[24]James Poterba, "Taxation and Corporate Payout Policy," NBER, Working Paper 10321, February 2004, pp. 6-7 – http://papers.nber.org/papers/w10321.pdf; Kevin A. Hassett, "Dividend Tax Cut Makes Sense," American Enterprise Institute, December 1, 2003 – http://www.aei.org/news/filter.,newsID.19615/news_detail.asp.

[25]JEC, "Who Benefits from Ending the Double Taxation of Dividends?" p. 8.

taxpayers in 10-percent and 15-percent tax brackets dropped to 5 percent. However, beginning in 2008, the rates drop to zero for these taxpayers.[26] At that point, lower-income Americans will be able to invest in stocks or mutual funds on a virtually tax-free basis – an incredible savings incentive that unfortunately expires after one year.[27]

The approaching expiration of the lower rates for dividends and capital gains poses a significant threat to retirement savings. Beginning in 2009, taxpayers will see a substantial increase in their taxes. Depending on their tax bracket, individuals will see every dollar of dividends reduced by 10 to 20 cents – and capital gains by 5 to 10 cents – in additional taxes owed to the government, as illustrated in Figure 6. In each case, individuals will have less of their return on investment to save for retirement. Furthermore, at the end of 2010, the lower individual income-tax rates enacted in the 2001 tax bill are scheduled to expire, which will increase the tax on dividends for nearly every taxpayer even further– to as much as 39.6 percent for individuals in the top tax bracket.

**Figure 6**

**Expiration of the 2003 Tax Bill**
**Effects on Dividend and Capital-Gains Tax Rates**

| Tax Bracket* | Return on Investment | 2008 Rate (Percent) | 2009 Rate (Percent) | Tax Increase (Percentage Points) |
|---|---|---|---|---|
| 10 percent (up to $7,950)<br>15 percent ($7,951-32,350) | Dividends | 0 | 10 - 15 | 10 - 15 |
| | Capital Gains | 0 | 10 | 10 |
| 25 percent ($32,351-78,400)<br>28 percent ($78,401-163,600)<br>33 percent ($163,601-355,750)<br>35 percent (over $355,750) | Dividends | 15 | 25 - 35 | 10 - 20 |
| | Capital Gains | 15 | 20 | 5 |

Source: Internal Revenue Code.
* Estimated income limits are for single taxpayers in 2009 based on 2005 actual limits adjusted for inflation using CBO inflation-rate projections.

Moreover, individual investors at all income levels are certain to react to the pending expiration of the dividend and capital-gains rate reductions. Between May 28, 2004, when the 2003 tax cuts were signed into law, and the end of 2004, the Dow Jones Industrial Average (DJIA) rose by nearly 2,000 points.[28] While a variety of factors may account for this substantial increase, the influence of the dividend and capital-gains rate reductions cannot be overlooked.

[26] Jobs and Growth Tax Relief Reconciliation Act § 301.

[27] In effect, these individuals will realize the benefits of the Administration's proposed Lifetime Savings Accounts (LSAs). If enacted, taxpayers would be permitted to make non-deductible contributions of up to $5,000 per year to an LSA, the earnings on which would not be taxed and the account could be used to save for any purpose, including retirement. For a explanation of the proposal, see the Treasury Department's "General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals," February 2005, p. 8 – http://www.treas.gov/offices/ tax-policy/library/bluebk05.pdf.

[28] See "Historical Prices" for DJIA Index (^DJI) at http://finance.yahoo.com/.

Since individuals tend to invest for the long term, they will likely respond to the looming expiration date by trading stocks to take advantage of the temporary low dividends and capital-gains rates. This, in turn, could roil the markets as 2008 approaches, adversely affecting long-term retirement savings.[29]

The lack of permanence also may well be preventing the rate reductions from reaching their full potential.[30] The significant number of new and increased dividend payments over the past year and a half likely represent the level that corporate management believes can be sustained in the worst-case scenario – the dividend-rate cut expires at the end of 2008.[31] And, as that expiration date approaches, the pressure for corporations to restrain their dividend distributions will undoubtedly increase.

If the success of the dividend and capital-gains tax cuts is to continue and they are to reach their full potential, Congress must make this growth-oriented tax policy permanent as quickly as possible. While critics complain that the cost is too high, they overlook that the reduced dividend and capital-gains tax rates mean far more than simply lower taxes for investors. Recent research demonstrates that up to half of the cost of a cut in capital taxes can be recovered through increased economic activity and the resulting increase in tax revenues.[32] That dynamic effect produces economic growth for the nation, and fuels Americans' retirement savings.

### *Financial Planning and Literacy: Implications for Successful Retirement Saving*

The 2001 and 2003 tax bills provided critical incentives to help Americans fulfill their responsibility to save for retirement. To attain retirement-income security, however, individuals must set realistic retirement goals and manage their savings effectively. From a variety of perspectives, it appears that too few Americans have the requisite financial skills to meet those challenges.

According to Federal Reserve Chairman Alan Greenspan, "one of the most complex economic calculations that most workers will ever undertake is without doubt deciding how much to save for retirement."[33] Recent research shows that only 42 percent of workers and/or their spouses have tried to make that calculation, and of those who have tried, 32 percent say that they do not know or cannot remember the results of their calculations.[34] Similarly, while many

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[29]"Tax Cut Worrywarts," *Wall Street Journal*, December 16, 2004.

[30]Congressional Budget Office, "Budget Options," February 2005, p.267-68 – http://www.cbo.gov/showdoc.cfm?index=6075&sequence=0.

[31]Robert D. Arnott and Clifford S. Asness, "Surprise! Higher dividends = higher earnings growth," *Financial Analysts Journal*, January/February 2003.

[32]N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," National Bureau of Economic Research, Working Paper 11000, December 2004 – http://papers.nber.org/papers/w11000.pdf. (Dr. Mankiw authored this paper in his personal capacity, not as the chairman of the President's Council of Economic Advisors.)

[33]Department of Labor, "Saving For A Lifetime: Advancing Generational Prosperity," 2002 National Summit On Retirement Savings, February 27-March 1, 2002, p. 7 – http://www.dol.gov/ebsa/pdf/summitfinalreport.pdf.

[34]Ruth Helman and Variny Paladino, "Will Americans Ever Become Savers? The 14th Retirement Confidence Survey, 2004," EBRI Issue Brief No. 268, April 2004, p. 9 – http://www.ebri.org/ibpdfs/0404ib.pdf.

financial planners recommend a retirement income of *at least* 70 percent of pre-retirement earnings (some even suggest 100 percent), more than a third of workers think they will need less than 70 percent in order to live comfortably in retirement.[35]

Even with realistic retirement-income goals, individuals must also have the financial skills to manage the assets they accumulate in their tax-deferred retirement plans and other savings accounts during their working years to achieve their goals. Research, however, has consistently shown that Americans are ill-equipped to handle these responsibilities. For example, a 2003 study based on the University of Michigan's Surveys of Consumers found that average households correctly answered only 67 percent of questions presented on credit management, savings, investment, mortgages, and other financial issues.[36] While average households scored higher on knowledge about savings – 77 percent – they only achieved a 63-percent score on investment skills. Similarly, a 2004 survey of defined-contribution plan participants revealed that individuals – 44 percent in 2004 – increasingly view themselves as having little or no investment knowledge, and 53 percent of respondents spend only 20 minutes or less per month managing or monitoring their retirement assets.[37]

From a policy perspective, Congress should continue to raise public awareness that financial literacy is essential for individuals to achieve retirement-income security. Americans should also be encouraged to improve their retirement-planning and financial-management skills by utilizing the valuable resources available through government sources[38] and non-profit organizations.[39] Moreover, since a substantial part of Americans' retirement savings occurs through employer-sponsored retirement accounts like 401(k) plans, the private sector is a vital avenue for helping individuals improve their financial literacy. According to a recent survey, 89 percent of large companies offer some type of financial education to their employees.[40]

Many companies, however, limit their financial education due to litigation concerns, and most stop short of offering personalized investment-advice services.[41] Businesses that are

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[35]Helman and Paladino, p. 6.

[36]Marianne A. Hilgert, Jeanne M. Hogarth, and Sondra G. Beverly, "Household Financial Management: The Connection between Knowledge and Behavior," *Federal Reserve Bulletin*, July 2003, p. 312 – http://www.federalreserve.gov/pubs/bulletin/2003/0703lead.pdf.

[37]Wayne Gates, "John Hancock's 2004 Survey of Defined Contribution Plan Participants," 18th Annual Symposium on Stable Value Investing, April 19, 2004.

[38]Examples of financial education resources offered by federal agencies via the Internet include: Federal Reserve, Personal Financial Education – http://www.federalreserveeducation.org/PFED/; Department of Treasury, Office of Financial Education – http://www.treasury.gov/offices/domestic-finance/financial-institution/fin-education/; Department of Labor, Retirement Savings Education Campaign - Saving Matters – http://www.dol.gov/ebsa/ savingmatters.html; Pension Benefit Guaranty Corporation – http://www.pbgc.gov/retire/default.htm/.

[39]While not an exhaustive list, some examples of non-profit resources on financial education include: American Savings Education Council – http://www.asec.org/; Jump$tart Coalition for Personal Financial Literacy – http://www.jumpstart.org/; National Endowment for Financial Education – http://www.nefe.org/pages/ educational.html; American Institute of Certified Public Accountants, 360 Degrees of Financial Literacy – http://www.aicpa.org/financialliteracy/.

[40]Hewitt Associates, "2003 Trends and Experience in 401(k) Plans," September 3, 2003 – http://was4.hewitt.com/hewitt/resource/newsroom/pressrel/2003/09-03-03.htm.

[41]See Department of Labor, Interpretive Bulletin 96-1, 61 Federal Register 113, June 11, 1996, p. 29586 (general guidelines for permissible investment information).

willing to provide their workers with access to professional investment advice are constrained by current law to hire an unaffiliated investment advisor to limit the business' liability and avoid tax penalties.[42] For many companies, especially smaller ones, the costs associated with such an independent advisor can be prohibitive.

One alternative would be for Congress to permit an employer to engage the financial-services firm that administers the company's 401(k) or other defined-contribution plan to provide investment-advice services to the company's employees.[43] Such a relationship would have to include safeguards to protect plan participants, such as full disclosure of all fees, any potential conflict of interest of the investment-advice provider, and the scope and any limitation of the investment advice to be provided.[44] By removing the barriers to employer-sponsored investment advice, more businesses would be able to enhance their retirement benefits by providing employees with access to individual investment advice at a reasonable cost.

While financial-management skills are vital for individuals to accumulate sufficient savings to meet their retirement goals, those skills become even more essential once a person retires. From that point on, financial literacy can mean the difference between an individual living comfortably in retirement and outliving his retirement savings.[45]

## Conclusion

With Social Security reform as a national priority, Congress has an important opportunity to take a broader view. By addressing the issue of retirement-income security for Americans, Congress can provide comprehensive solutions and remind individuals that they have an obligation to provide for their retirement, in large measure through personal savings during their time in the workforce.

Over the past four years, Congress has provided significant incentives and lower tax rates to foster an economic environment conducive to successful retirement savings. However, the approaching expiration of the 2001 and 2003 tax bills threatens to turn these improvements in the nation's tax policy into new obstacles for Americans trying to achieve retirement-income security. For most Americans, the challenge of planning for a secure retirement is already a daunting task – one that could be made far easier if the uncertainty were removed from the tax code.

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[42]See Employee Retirement Income Security Act, Public Law 93-406, §§ 3(21)(A)(ii) and 406 (29 U.S.C. §§ 1002(21)(A)(ii) and 1106) (concerning investment advice and prohibited transactions); and Internal Revenue Code § 4975 (concerning the tax imposed on prohibited transactions).

[43]See S. 1698, "Retirement Security Advice Act of 2003," 108th Congress.

[44]See S. 1698, § 2(a)(2).

[45]Craig Copeland, "Changes in Wealth for Americans Reaching or Just Past Normal Retirement Age," EBRI Issue Brief No. 277, January 2005 – http://www.ebri.org/ibpdfs/0105ib.pdf.