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Mr. Chairman, Mr. Vice Chairman and other Committee Members, my name is Robert Pozen. I am currently Chairman of MFS Investment Management and a visiting professor at Harvard Law School, though I am here today in my personal capacity rather than representing either institution. I was formerly a member of President Bush's Commission to Strengthen Social Security.

I congratulate the Joint Committee on its efforts to promote savings by Americans. The present savings rate of Americans is low relative to the savings rate in other industrialized countries, and relative to the savings rate in the United States from a historical viewpoint. If we are to grow our economy at a satisfactory rate and provide sufficient income during retirement, Americans need to save more.

While the subject of promoting savings is broad, today I will focus on the relationship between personal contributions to Individual Retirement Accounts (IRAs) and government expenditures through Social Security. These are two programs for retirement that have typically been addressed through separate measures. However, from the viewpoint of a retiree, the programs are closely linked. The income of a retiree is the total of what he or she receives from Social Security and from private retirement programs like IRAs.

I want to begin by proposing two ways to increase personal savings through IRAs and other tax deferred retirement plans such as 401(k) plans. Roughly 60% of U.S. households have income under $50,000 per year, while roughly 40% of U.S. households have income above that amount (according to statistics gathered by the Board of Governors of the Federal Reserve System). But these statistics show a big difference between these groups with regard to participation in IRAs and other tax deferred

retirement plans. Less than one third of households with incomes under $50,000 per year participate in such plans, while over two thirds of households with incomes over $50,000 per year participate in such plans. Moreover, households with incomes below $25,000 per year on average derive over 90% of their retirement income from Social Security because their participation rates in IRAs and other tax deferred retirement plans are minimal.

As a practical matter, it is very difficult for households with incomes under $50,000 per year to save today. In many areas of the country, a family of four earning less than $50,000 per year is struggling to make ends meet. Nevertheless, I believe that many households with annual incomes between $25,000 and $50,000 per year could become savers if properly incentivized. The most powerful incentive to save for retirement is a matching grant from someone else, as demonstrated by years of experience with 401(k) plans. In the context of these plans, an employer match of 50% of an employee's contribution often doubles the participation rates of employees.

Congress recently introduced a kind of matching for couples with annual incomes below $50,000 in the form of a tax credit against federal income taxes for up to 50% of their contributions to IRAs and other tax deferred retirement plans. While this tax credit is a good start, its value is diminished because it applies only to the extent a household is paying federal income taxes. With lower tax rates and more generous deductions, many families with annual incomes below $50,000 pay little or no federal income taxes. For example, a family of four with two children and an annual income of $40,000 would typically pay less than $100 of federal income taxes. The solution is for Congress to make this low-income tax credit refundable to the extent that households have

insufficient federal income tax to offset so long as the tax credit is invested in a long-term retirement account. Assuming the current low-income tax credit is made permanent, my rough estimate is that this new refundability feature would cost less than $1 billion per year for the next decade.

Households with annual incomes over $50,000 per year typically have enough resources to save for retirement. The challenge is to overcome the inertia that appears to prevent some workers from opening retirement accounts. In an effort to overcome this type of inertia in 401(k) plans, Professor Thaler has suggested a negative election procedure for 401(k) plans (as opposed to the positive election or opt-in required under current law). In a negative election, a company with a 401(k) plan would automatically enroll all workers in its plan and contribute a specified percentage of their salary to the plan, unless they opted out. This switch from an opt-in to an opt-out in 401(k) plans would be a powerful tool in the effort to increase retirement savings in America.

However, we know that many employers with fewer than 100 workers do not currently offer them any type of retirement plan. Congress has tried to address this problem by introducing the SIMPLE plans — which are exactly what the name implies. They reduce the paperwork and eliminate many of the complex requirements involved with defined contribution plans. While the SIMPLE plans have gained a measure of popularity, there still is a retirement plan gap for those working for many small employers.

I propose that Congress extend Professor Thaler's opt-out concept to any employer that does not offer its employees any type of retirement plan. Under this ULTRA SIMPLE plan, 1% of the wages of all qualifying employees would be

automatically contributed to an IRA at any qualified financial institution, unless the employee opted out of the plan. The burden would be minimal on small employers because many financial institutions are prepared to do most of the work in order to attract the contributions. And I would provide an extra incentive by giving banks CRA credit for offering an ULTRA SIMPLE plan. In addition, to reduce the burdens associated with part-time or seasonal workers as well as the costs inherent in small accounts, I would limit the 1% contribution to one transfer just after year end and I would limit a qualifying employee to someone with a specified level of annual earnings (e.g., $25,000 per year or a 1% contribution of $250 per year). Furthermore, the 1% contribution would be automatically invested in a money market deposit or money market fund unless the employee made a different choice.

If we could substantially increase the participation in private retirement plans, we would then be in a position to think creatively about the relationship between these plans and Social Security. In general, Social Security should be viewed as providing a floor of defined retirement benefits, which are supplemented by a variable stream of benefits from private retirement plans. The critical question is: how much of a worker's retirement income should be composed of defined benefits versus variable benefits? In my view, the answer depends on the level of a worker's earnings.

Low wage workers earning $25,000 or less per year need most of their retirement in defined benefits from Social Security; as mentioned above, these low wage workers do not tend to participate in IRAs or 401(k) plans. Even if we introduce a refundable tax credit to match their contributions to these plans, wage earners at $25,000 per year and below will be hard pressed to save for retirement. As to high earners over $100,000 per

year, most of their retirement income should be in the form of variable benefits from private retirement plans. Most of these earners already participate in IRAs and 401(k) plans. The middle-level earners need a mix of defined benefits from Social Security and variable benefits from private retirement plans. The proportions of the mix should depend on whether their earnings are closer to $25,000 per year or $100,000 per year.

To implement these "mix" objectives for different groups of earners requires an understanding of the two types of indexing used in Social Security — price and wage indexing. Most people are familiar with the COLAs of Social Security, whereby benefits after retirement are adjusted annually based on changes in prices to protect against inflation. By contrast, when the initial level of Social Security benefits are determined at the date of retirement wage indexing is applied. That is, the average career wages of each retiring worker is increased by the rate wages have risen in the whole American economy during his or her working career.

Since wages rise approximately 1.1% faster per year than prices, the use of wage rather than price indexing of initial benefits has a huge impact on Social Security's finances. An immediate switch from wage to price indexing of initial benefits would eliminate the whole long-term deficit of Social Security! But such a switch would also lower the "replacement ratio" for retiring workers.

The replacement ratio means the percentage that Social Security payments replace of the worker's average wages before retirement. If you earned $80,000 a year before retirement and received $32,000 in Social Security benefits after retirement, your replacement ratio would be 40% and you would very likely have other sources of income from private retirement plans. On the other hand, if you earned $20,000 a year before

retirement and received $8,000 per year in Social Security benefits after retirement, your replacement ratio would also be 40% but you would probably not have other retirement income and would have difficulty living on $8,000 per year.

Therefore, if we want to achieve our "mix" objectives by income group, we should maintain wage indexing of initial Social Security benefits for low-wage workers, while gradually introducing price indexing for middle and high wage workers. In 2012, for example, we could maintain wage indexing for all retiring workers with average career earnings of $25,000 per year or less — the lowest 30 percent of all retiring workers. At the same time, we could have price indexing for all retiring workers with average career earnings of $113,000 per year or more — the maximum wages subject to Social Security taxes in 2012. All workers between $25,000 and $113,000 per year would receive a mix of price and wage indexing based on a proportional formula.

Accordingly, the retirement income of low earners at $25,000 and below would be comprised mainly of Social Security benefits, which would grow relatively quickly for their working years through wage indexing. The retirement income of high earners would be comprised of a modest portion of Social Security benefits, which would grow relatively slowly for their working years under price indexing, plus a large portion from their private retirement plans. The retirement income of middle earners would be comprised of some Social Security benefits, growing for their working years through a mix of wage and price indexing, and other income from their retirement plans. Those earners between $25,000 and $50,000 per year would have been encouraged to contribute to private retirement plans through refundable tax credits.

In summary, this blend of price and wage indexing for Social Security, together with enhanced incentives to save through private retirement plans, would result in the appropriate mix of defined and variable benefits by income group. And, as an added bonus, this proposal would close over two thirds of the long-term deficit of Social Security.

Thank you again for this opportunity to present these proposals. Would be glad to answer any questions a Committee member might have.