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National Center for Policy Analysis
Retirement Reform Initiative

Briefing Book

Section 1: Social Security

Social Security is the cornerstone of retirement security in the United States today. A third of Americans depend on the program for almost all their retirement income; without it, one-in-five would have no retirement income. But the program so many depend on simply cannot afford what it promises today's workers, and faces a shortfall of more than $4.7 trillion over the next 75 years. Reforms are desperately needed.

Key Facts about Social Security

- Social Security provides retirement and disability benefits for qualified workers and their dependents, as well as benefits for survivors of deceased workers.

- In 2008, Social Security is projected to pay retirement and survivors benefits to more than 41 million people and disability to about 9 million. Meanwhile, 163 million workers will contribute.

- Social Security is a pay-as-you-go program, which means the government writes checks to today's beneficiaries using payroll taxes collected from today's workers.

- When Social Security began in 1935, the payroll tax on workers' salaries to support the program was 2 percent on the first $3,000 of income; today, Social Security is financed by a 12.4 percent payroll tax — half by the employee and half by the employer — on the first $102,000 of wages (about 11 million workers have wages above the cap).

- The average Social Security benefit in 2007 for retired workers was $1,084 per month, or $13,008 per year.

- Sixty-four percent of retirees depend on Social Security for half or more of their income, a third (32 percent) of beneficiaries rely on Social Security for 90 percent or more of their retirement income, and one-in-five rely on the program for all their retirement income.

Social Security is in Trouble.

- The number of Social Security beneficiaries is growing faster than the number of workers supporting them — the number of elderly will nearly double between now and 2034 (38.6 million to 74 million) while the number of new workers will only increase 16 percent.

- People are living longer and collecting more Social Security benefit checks: In 1940, life expectancy was 61.4 for men and 65.7 for women. By 2000, life expectancy was 74.2 years for men and 79.5 for women; by 2050, life expectancy will be 80.0 years for men and 83.4 for women.

- Fewer children are born now than in 1940: For each generation to be the same size as the one before (the replacement rate), women must have 2.1 children. In 1940, the fertility rate was 2.23. Today, the rate is 2.10 but will trend upward to 2.19 by 2050.

- The result has been dramatic. In 1940, there were 42 workers per retiree. Today the ratio is 3.3-to-1; by 2050 it will be 2-to-1. The burden on each individual worker will increase substantially and we will no longer be able to keep our promises to retirees at current payroll tax levels.

- By 2017 Social Security will spend more in benefits than it collects in taxes; by 2041 the program will have spent all the assets credited to the trust fund and the program will only be able to afford three-quarters of promised benefits.

- In all, the program faces an unfunded liability (the amount Social Security promises in benefits above what it will collect in taxes) of more than $13.6 trillion.

Trust Fund: Accounting Fiction?

- The real problem comes in 2017: Currently, payroll tax collections exceed benefit payments, and will continue to do so until 2017 when the program will spiral into annual deficits.

- Surpluses credited to the trust fund are not saved or invested. Rather, they are immediately borrowed by the government and spent on other priorities or used to pay down debt. All that remains in the trust fund are government IOUs.

- For the government to pay Social Security benefits in 2017, it must first raise taxes or reduce spending to generate the needed funds.

How to Fix the Problem.

- To shore up Social Security's financial shortfall, the government must increase the program's income (raise taxes), decrease expenses (reduce benefits) or find a new source of funding.

- One way to create a new funding source is to allow younger workers to invest a portion of their payroll taxes into a personal retirement account (PRA). Over time, the PRA balances — with their accumulated interest and dividends — would replace an increasing portion of retirees' Social Security benefits, saving future tax payers trillions of dollars.

NCPA Policy Recommendations

Ideally, U.S. decision makers would eliminate Social Security’s long-term debt by integrating personal retirement accounts (PRAs) into the current system.

However, in the current political environment, a compromise solution may be required. NCPA scholars are working with scholars at the Brookings Institution to develop a politically feasible right-left consensus reform plan. The plan would include the following elements:

- Restrain the growth in future benefits for the highest earners.

- Automatically enroll all workers in a voluntary private account outside Social Security with deposits equal to about 3 percent of wages.

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Section 2: Private Pensions

For decades, companies have been freezing or closing their traditional defined benefit plans and moving employees into defined contribution plans like 401(k)s. The reasons vary from company to company, but are largely a result of the growing costs of providing future benefits, the administrative burden of complying with federal pension laws and workers' mobility. The perpetual underfunding of defined benefit pension plans — for which taxpayers are largely on the hook if the plans must be bailed out — prompted Congress to pass legislation in 2006 that will force companies to fund their plans.

Key Facts about Private Pensions

After World War II, the dominant form of retirement plan provided by employers was the defined benefit pension. Under these plans, employees acquire pension benefits based on their wages and years of service to the company. The plans make a promise — backed by the employer — for a specific amount of money to each employee. Pension benefits for employees who remain with an employer for their entire work lives are typically 60 percent to 70 percent of final salary. Although millions of employees still participate in such plans, virtually no new defined benefit plans are being established today.

The news cycle has been dominated in recent years by firms with household names that closed their traditional defined benefit plans to new hires or completely eliminated their plans: Alcoa, Hewlett-Packard, IBM, Sears, United Airlines, Verizon, etc. It is no wonder why. With the baby boomers nearing retirement and pension promises coming due, many companies can no longer afford to keep them. Consider General Motors, which has a pension liability of $90.9 billion. As one observer noted, “General Motors is no longer an automotive company. General Motors is a benefit company that sells cars to fund those benefits.”

- The number of defined benefit plans in the private market has declined from 103,346 in 1975, to 47,000 by 2004.

- By contrast, the number of defined contribution plans has risen dramatically from 207,748 in 1975, to almost 653,000 by 2004.

Today, there are about 42 million total participants in defined benefit plans (including active workers retirees and vested participants not in pay status) versus 65.3 million workers enrolled in defined contribution plans. Given the trends in the private sector, the number of people enrolled in defined benefit plans will shrink, while the number enrolled in defined contribution plans grows.

Problems with Defined Benefit Pensions. For most of the post-war period, employers were not required to fund their pension plans. Like today’s Social Security system, pension promises often were not backed by any saving or investment. This meant many pension plans were only as secure as the company that established them. If the employer went broke, employees could lose some or all of their benefits. For example, after Studebaker filed for bankruptcy in 1963, its autoworkers received only 15 percent of the pension benefits they had been promised.

Congress passed legislation that required all employers with defined benefit pension plans to begin to fund those plans. The act also created the federal Pension

Benefit Guarantee Corporation (PBGC), which provides insurance for private pension plans.

- In 2008, PBGC will insure more than $2.5 trillion in pension benefits.
- It paid $4.27 billion in benefits to more than 631,000 annuitants whose plans had been terminated and currently owes benefits to another 673,000 workers when they retire.

This insurance does not work like insurance in a normal market, however. All companies with defined benefit pension plans are required to pay premiums to the PBGC. But the premiums paid by those who are at risk of default are much lower than their actual risk warrants. Fully-funded plans at virtually no risk of default are charged premiums that are too high. Thus, one way to think of this system is to see it as socializing the risks of pension default by overcharging healthy plans and undercharging sick plans.

Problem: Unfunded Promises. While the PBGC has provided pension insurance for more than three decades, the agency's financial situation has deteriorated rapidly over the past several years. As an insurer, the PBGC is at the whim of decisions made by plan sponsors, the variability of the private equity market and the financial condition of the plan sponsors. The swing in the program's financial position over the past several years is the combined effect of an economic downturn, low interest rates and the termination of a number of large pension plans that dramatically increased the program's obligations. According to the Congressional Budget Office, the underfunding of all insured corporate pension plans (not just those currently administered by PBGC) amounts to more than $450 billion.

Under current funding rules, even sponsors of badly underfunded plans can continue to allow employees to accrue additional benefits, and can even make benefits more generous. Plan sponsors in financial trouble and nearing bankruptcy can promise larger pension benefits instead of pay increases, and employees may go along because of PBGC guarantees. Current rules also allow companies to substantially understate the financial position of their plans. For example:

- Prior to declaring bankruptcy, Bethlehem Steel reported its plan was 84 percent funded, but when the plan was terminated it had assets adequate to cover only 45 percent of benefits promised; in fact, for the three years immediately preceding the termination of its plan, the company was able to avoid making contributions to its plan.

- U.S. Airways reported that the pension plan for its pilots was 94 percent funded, but the plan had assets adequate to cover only 33 percent of benefits when it was terminated; the company avoided making any contributions for the four years preceding the plan's termination.

Problem: Inflexibility. Even if all plans were fully funded, problems would remain. Defined benefit plans work well for people who stay with the same employer, but they do not work well for employees who switch jobs. Almost all of these plans calculate benefits under formulas that are "back-loaded." That means the 40th year is weighed a lot more heavily than, say, the 10th year.

To see what this means in practice, consider a man who works for four different companies — each for 10 years. All four have identical pension plans and the worker fully vests in each one. Upon retirement, he will get four separate pension checks, but his combined income will be less than half of what it would have been if he had stuck with just one company for the full 40 years.

Under this system, people sacrifice substantial pension benefits if they switch employers frequently throughout their career, even though they remain fully employed for their entire work lives. Accordingly, these plans have become less attractive to employers who need to provide a benefit that is suited to the dynamic labor market and to employees participating in that market.

Solution? The Pension Protection Act of 2006. In response to these challenges, the government enacted a pension reform measure to force companies with underfunded plans to shore them up. The new law reduces the probability of a taxpayer-funded bailout of the PBGC by tightening the rules used to calculate pension liabilities, requiring additional contributions from poorly funded plans and limiting certain benefits poorly-funded plans can provide. It also increases PBGC premiums to reduce the program's debt and establishes uniform vesting schedules and disclosure requirements. The Congressional Budget Office estimates the new law will increase the PBGC's premium receipts by $5 billion from 2007 to 2016.

Ironically, while the law is supposed to shore up defined benefit plans, it may well encourage many employers to close them because it makes them more expensive to operate. If that is the case, it will be because the law forces companies to come to terms with the cost of their promises, which is something the market should have been doing all along. Without the new law, many of the employees who are gradually shifted out of defined benefit plans might otherwise have met a sudden, dramatic loss of benefits near or during retirement when their underfunded plans collapsed.

However, due to higher-than-expected returns and efforts to comply with the new pension reform bill, the situation is improving. A study by the actuarial firm Milliman USA that examined the 100 largest defined benefit plans shows some of the nation's largest corporate pension plans improved their financial status significantly in 2006.

NCPA Policy Recommendations

- **Full Funding.** Congress is already taking steps to reduce the underfunding of plans by increasing premiums paid by plan sponsors, cutting the time required for companies to fully fund underfunded plans, and tightening rules for what constitutes a funded plan. Decision-makers should avoid the temptation to soften the rules or exempt favored industries. Taxpayers should not have to bail out companies that have over-promised and underfunded their pension plans.

- **No Back-Loading.** Historically, back-loading was adopted by employers both to reward long-serving employees for loyalty and to discourage job hopping. But this feature is inconsistent with the needs of a mobile labor market. To keep pace with today's dynamic workforce, federal policy should encourage employers to move as soon as possible to a system under which workers are not penalized because they change jobs.

- **Immediate Vesting.** Another tool employers have used to retain employees or reward longer service is vesting. Vesting means that employees must work for an employer a certain number of years before they obtain full rights to the promised retirement benefits. An employee who leaves before fully vesting in a defined benefit plan will receive a smaller pension as a result. Why have vesting at all? The issue is similar to back-loading. A short vesting period makes sense to allow the employer to recover some administrative costs for employees who pop in and out of employment.

- **Full Portability.** Defined benefit pensions are generally not "portable," which means that they cannot be rolled over into an Individual Retirement Account (IRA) or the employee's next plan to grow for the future. Benefits are typically "frozen" in the former employer's plan until the scheduled retirement date. This feature is not optimal in a labor market in which employees frequently change jobs. For example, workers ages 18 to 42 have held an average of 10.8 different jobs.

- **No Government Pension Insurance.** Today, a company that wants to voluntarily terminate a defined benefit plan purchases private insurance. The firm pays a highly rated insurance company to assume its pension obligations. We should consider requiring all employers to contract with financial firms to provide the benefits. During the transition, PBGC must keep collecting premiums from employers to meet their existing claims, but no new obligations should be taken on by this agency.

- **Full Disclosure.** The two groups with the biggest financial stake in the health of a company's defined benefit pension plan are shareholders and employees. Unfunded pension plans lead to lower shareholder equity and put employee retirement security at risk. Requiring companies to fully disclose the status of their pension plans serves both groups, in addition to company executives and government watchdogs.

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Section 3: Private Retirement Accounts

Private retirement accounts include employer-sponsored 401(k)s and privately-purchased plans like Individual Retirement Accounts (IRAs) of all types, including traditional, Roth and Spousal IRAs. With government programs over-promising benefits and benefit cuts increasingly likely, Americans must save more on their own. But rules and regulations on private accounts make that difficult for some. For a quick summary, see the table at the end of this section.

Key Facts about 401(k)s

- Today more than 54 million workers participate in 401(k)-type plans, with total assets of about $2.4 trillion.

- About a quarter of employees (24 percent) with access to a 401(k) do not contribute. The participation rate is much worse among younger workers and those with lower incomes:

    - Almost three-quarters of 40- to 59-year-old employees participate (73.7 percent to 74.2 percent) versus less than half (47.5 percent) of those ages 29 and younger.

    - Almost half of employees earning more than $75,000 participate (45.2 percent) versus just 7.4 percent of those earning less than $10,000.

- Congress made it easier for workers to prepare for retirement by passing the Pension Protection Act of 2006. The new rules took effect beginning in 2008 and encourage (but do not force) employers to offer:

- *Automatic Enrollment*. New employees are automatically part of an employer's plan and must opt out if they don't want to participate.

- *Automatic Escalation of Contributions.* Unless they opt out, employees' contributions will automatically rise to equal 3 percent of compensation by the end of the first year, 4 percent in year two, 5 percent in year three and 6 percent thereafter.

- *Matching Contributions.* An employer must match the first 1 percent of compensation the employee contributes dollar-for-dollar, and 50 cents for each additional dollar up to 6 percent of compensation (for a total of 3.5 percent), or contribute at least 3 percent of compensation to the account of every participating employee, regardless of the employee's contribution. The employer's contributions must fully vest after the employee completes two years of service.

- *Diversified Investment Options.* The law also encourages employers to offer at least three different investment options — other than employer stock — that are diversified and have different levels of risk.

Key Facts about IRAs

Some workers do not have access to a 401(k) plan because they work for an employer that does not offer one. Others may choose not to join, perhaps because the plan has too few options or is poorly administered. Tax-advantaged savings can produce more than twice as much retirement income as comparable taxable investments, depending on a person's tax bracket. Thus, an IRA is one of the best ways to save when one doesn't have access to an employer-sponsored plan.

- **Income Restrictions for Traditional IRAs**: The tax deductibility of IRA contributions phase out for people with moderate or higher incomes who are participating in an employer's qualified retirement plan:
    - IRA contributions are fully deductible for singles with an adjusted gross income (AGI) up to $53,000 and couples who are married filing jointly with an AGI up to $85,000.
    - However, the deductibility of contributions phases out at incomes above these levels; singles with an AGI of $63,000 or more — and couples who are married filing jointly with an AGI of $105,000 or more — get no deduction for contributions to traditional IRAs.
- **Different Retirement Savings Rules for Working vs. Not Working.** Employer-sponsored 401(k)s have higher contribution limits and no income limits, unlike other tax-favored investment vehicles like IRAs:
    - **Different Contribution Levels for IRAs and 401(k)s:** Participants in an employer-sponsored 401(k) plan can contribute up to $15,500, while nonparticipants can contribute only $5,000 ($6,000 if age 50 or older) to a tax-advantaged IRA (both Roth and Traditional IRAs).
    - **Special Issue — Spousal IRAs**: Unlike other IRAs, spouses with no earned income (or some earned income, but not enough to fully fund an IRA) can qualify for a Spousal IRA. The contribution limit is $5,000 per

year ($6,000 if age 50 or older), the same as traditional and Roth IRAs — assuming the wage-earning spouse earns at least that amount in wages. (For additional rules, see the table.)

Key Facts about Roth Accounts

Traditional retirement savings vehicles, such as 401(k)s and IRAs, are tax-deferred accounts. They allow people to invest pretax dollars, but taxes must be paid on the investment and accumulated earnings at the time of withdrawal. By contrast, deposits to Roth IRAs or Roth 401(k)s are made with after-tax dollars and withdrawals are tax-free. Americans have invested more than $145 billion in Roth IRAs. In 2010 all taxpayers, regardless of income, will be able to convert their regular IRAs into Roth IRAs. For a comparison of contribution limits and other differences between Roth and traditional accounts, see the table.

Who Benefits from Roth Taxation? Which is better, a regular account or a Roth account? The answer depends on a worker's marginal tax rate during the working years compared to the tax rate faced during retirement. In general, one wants to pay taxes when the tax rate is lowest. The traditional assumption has been that people will be in a lower tax bracket after they retire, so investing pretax dollars and paying taxes when the money is withdrawn means they will pay less taxes over their lifetime. But there are two reasons this assumption may to be wrong — especially for many young people:

- First, many moderate-income families will be pushed by the Social Security benefits tax into higher tax brackets after they retire than when they were working.

- Second, as the baby boomers age and retire, the costs to society of providing Social Security, Medicare and Medicaid benefits will most likely lead to higher taxes across the board; it is probably a safe bet that tax rates will be higher in the future.

NCPA scholars used a financial planning model developed by economist Laurence Kotlikoff to determine whether a Roth account or a regular account is better for workers at different income levels:

- A family earning $75,000 will face an 18 percent marginal tax rate while working and a 24 percent tax rate in retirement; thus, they are better off with a Roth.

- Families earning $35,000 and $125,000 face higher marginal tax rates while working than when retired; thus, they are better off with a traditional IRA.

Restrictions & Rules for Roth IRAs.

- Taxpayers who file as a single with an adjusted gross income more than $114,000 cannot contribute to a Roth IRA, and cannot make the full contribution ($5,000, or $6,000 if age 50 or older) if their adjusted gross income is between $99,001 and $114,000.

- Taxpayers who are married filing jointly cannot contribute to a Roth IRA if their adjusted gross income is greater than $166,000, and can only make a partial contribution if their income is between $156,001 and $166,000.

New in 2006: Roth 401(k)s. Currently, 401(k) plans are taxed like ordinary IRAs. Contributions are made with pretax dollars and people pay income taxes on the contributions plus earnings when funds are withdrawn. Starting this year, however, employers can offer Roth 401(k)s. Workers can contribute after-tax dollars to an employer-sponsored Roth 401(k) plan, and the money will grow tax-free and eventually be withdrawn tax-free. The new plan is similar to a Roth IRA, in that it lets savers contribute after-tax money that grows tax-free. But Roth 401(k)s differ from Roth IRAs in a few key areas: Roth 401(k)s have no income limits for participation, and the same higher contribution levels and penalties for withdrawals before age 59½ as traditional 401(k)s.

NCPA Policy Recommendations

- **Additional 401(k) Reforms.** The 2006 pension law made a number of productive reforms to private retirement savings accounts. Unfortunately, a key provision is missing from the pension bill: a lifetime annuity. Longer lifespans — and the need to draw from retirement savings for more years — increase the risk of outliving one's retirement savings. Encouraging 401(k) plans to offer a lifetime annuity as the default payout option at retirement would go a long way toward addressing this potential problem. A lifetime annuity is a financial contract with an insurance company; in exchange for a lump-sum payment — for example, the savings accumulated in a 401(k) — the insurance company guarantees regular payments for as long as the beneficiary lives. It is basically a paycheck for life.

- **Expand Individual Retirement Accounts (IRAs)**. Current tax law penalizes those who do not have employer-sponsored savings plans. For example, participants in an employer-sponsored 401(k) plan can contribute up to $15,500 annually, while nonparticipants can contribute only $5,000 to a tax-advantaged IRA. This policy is particularly harmful to early retirees. We need a level playing field that treats all savers equally.

- **Create Universal Roth IRAs**. Given the effects of the Social Security benefits tax and the expectation of higher tax rates in the future, Roth taxation makes sense for many younger taxpayers. Simplify and unify the many retirement savings vehicles by creating universal Roth IRAs.

- **Extend Incentives for Saving and Investment**. Permanently extend the 2001-2003 tax cuts for capital gains, dividends and estates, as well as the higher contribution limits on retirement savings accounts.

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Retirement Account Contribution & Income Limits, 2008

	Contribution Limit	Contribute Until?	Income Phase-Out	Other Rules
IRA	$5,000 ($6,000 age 50+)	Age 70.5	$ 85,000 to $105,000 AGI for couples*	Cannot withdraw before age 59.5 Must begin withdrawing at age 70.5
Roth IRA	$5,000 ($6,000 age 50+)	No Limit	$159,000 to $169,000 AGI for couples*	Cannot withdraw before age 59.5 No mandatory withdrawals
Spousal IRA	$5,000 ($6,000 age 50+)	Age 70.5	$ 85,000 to $105,000 AGI for couples*	Cannot withdraw before age 59.5 Must contribute “earned” income Must begin withdrawing at age 70.5
Spousal Roth IRA	$5,000 ($6,000 age 50+)	No Limit	$156,000 to $166,000 AGI for couples*	Cannot withdraw before age 59.5 Must contribute “earned” income No mandatory withdrawals
401(k)	$15,500 ($20,500 age 50+)	No Limit	No Limit	Cannot withdraw before age 59.5 Must begin withdrawing at age 70.5
Roth 401(k)	$15,500 ($20,500 age 50+)	No Limit	No Limit	Cannot withdraw before age 59.5 No mandatory withdrawals

* Traditional IRA contributions are fully deductive for singles with adjusted gross income (AGI) below $53,000 and couples below $85,000. Deductibility phases out above that level and there is no deduction for singles with an AGI of $63,000 or more and couples with an AGI of $105,000 or more. Roths have different rules. Singles with AGIs between $101,000 and $116,000 — and couples with AGIs between $159,000 and $169,000 can not make the full contribution to a Roth IRA. Singles with AGIs above $116,000 and couples above $169,000 cannot contribute at all. For Spousal IRAs, the entire contribution is deductible if the working spouse does not have an employer-sponsored plan. However, if the working spouse has an employer-sponsored retirement plan, contribution to a Spousal IRA may not be entirely deductible.

Section 4: State & Local Employee Retirement Benefits

The national debt is over $9.6 trillion, and state and local debts total $1.95 trillion. Taxpayers are on the hook for all of it, since it must be repaid at some point, lest interest payments swamp government budgets. Taxpayers are also on the hook for the $101.7 trillion in unfunded promises through Social Security and Medicare. But there is another debt on the horizon that has received little attention: The growing unfunded liabilities of state and local employees' retiree benefits.

Key Facts about Public Employee Retirement Benefits

- About 18.4 million people (including about 7.3 million beneficiaries in payment status) participate in 2,656 state and local government pension plans across the country.
- About 90 percent of all state and local government workers participate in a defined benefit plan (versus only 24 percent of private sector workers).
- It is difficult to compile aggregate data on the health of public pension plans or compare one plan with another: There is no central regulative body — like the Pension Benefit Guarantee Corporation (PBGC) for corporate pension plans — that gathers data for public pension plans; nor are public pensions accountable to a central enforcement agency like the Securities and Exchange Commission. And there are also no uniform accounting standards.
- The "Public Fund Survey," an online compendium of key characteristics for 125 large public pension plans, finds the funds in its catalogue are 86.1 percent funded, with a reported unfunded liability of more than $392 billion.

- Analysts at Barclays Global Investors say the problem may be much worse — because public plans often avoid the stricter accounting standards that are the norm in the private section — in excess of $800 billion.

<u>Public Employee Retiree Health Benefits</u>.

- For the first time ever, taxpayers and bondholders will learn the cost of health care promises state and local governments are making to their employees: New rules passed by the Government Accounting Standards Board — which sets accounting and financial standards for government entities — will require government entities to disclose the cost of "Other Post Employee Benefits," or OPEBs, which include medical, dental, vision, hearing and life insurance benefits.
- For all state and local governments, total OPEB liabilities are estimated at $1.5 trillion, including $558 billion for state and $951 billion for local governments.
- Annual pay-as-you-go benefits are estimated at $21 billion a year.

<u>Unique Problems with Public Pensions</u>.

- **Very Little Oversight**: Corporate plans must disclose timely information about their plans to investors and the SEC, must follow rules set by the Employee Retirement Income Security Act and operate under the watchful eye of rating agencies. By contrast, public plans are under far less scrutiny.
    - The Governmental Accounting Standards Board (GASB) — an independent, private-sector, not-for-profit organization — is recognized as

the entity that establishes standards of financial accounting and reporting for state and local governments. But the GASB is not a federal agency, and it does not have authority to enforce its rules or police compliance.

- In January 2006, the GASB began looking for ways to tighten the accounting and reporting rules for public plans. Partially, the move was in response to the worsening condition of public plans, but was spurred by Congress' debate over the Pension Protection Act of 2006. Stronger uniform rules will help public officials, taxpayers and bondholders see how big the promises are, but the GASB will still have no power to compel sponsors of underfunded plans to fill the gap.

- **Benefit Promises are Growing**. Annual benefits paid to retired state and local employees in the U.S. increased 33 percent (after adjusting for inflation) between 2000 and 2004, due largely to the baby boomers reaching the typical retirement age in public systems — often the ripe old age of 55, versus, say, age 62 under Social Security — and rising benefit promises.

- **Pension Obligation Bonds**. Participants in underfunded public pension plans do not have the PBGC to lean on; taxpayers are the insurer of last resort. Over the past several years, some state and local governments have turned to an instrument called "pension obligation bonds" to finance their plans. In fact, state and local governments raised more than $33 billion between 1993 and 2003 using these special issue bonds.

- **Constitutional Protection**. Private sector pension reform was driven largely by a desire to provide greater financial security to current and future retirees threatened by corporations declaring bankruptcy and dumping their plans. The public sector is different: Arguably, governments can't go out of business. Besides, if they did, it is unclear whether it would clear pension promises off the books since many benefits are guaranteed by state law or statue.

NCPA Policy Recommendations

State and local governments with sinking plans have few options to bail them out, and none are easy. But by acting now, rather than waiting, the solutions can be eased in, providing younger workers the opportunity to prepare for whatever reforms are adopted:

- **States and Municipalities Should Fully Fund their Pension Plans**. State and city leaders should properly account for their promises and ensure they are fully funded.

- **Shift to Defined Contribution Plans**. Traditional defined benefit plans are ill-suited for today's aging and mobile workforce. The public sector — particularly state and local governments with under-funded pension plans — should follow the example set by the private sector and transition their employees to defined contribution plans like 401(k)s.

- **Determine Obligations for Retiree Health Benefits**. Policy makers at the state and local level need to accurately account for their retiree health obligations to public employees, and fund the unfunded liabilities.

- **Shift to Consumer Directed Health Care**. State employees should have access to Health Savings Accounts, which will help them control health spending while saving for their health needs in retirement.

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Section 5: Medicare

While Social Security received considerably more attention in recent years, Medicare is actually a much larger problem. Medicare is growing at a faster rate and has an unfunded liability six times the size of Social Security. The program is on a spending path that is impossible to sustain. It must deal not only with the demographic pressures Social Security faces, but also the soaring cost of medical care.

Key Facts about Medicare

- Medicare faces the same demographic pressures as Social Security — a growing elderly population and a shrinking birthrate — but also must contend with the soaring cost of medical care.

- By 2020 the deficits in Medicare will claim more than one in every five federal income tax dollars.

- This means that in just 12 years the federal government will have to stop doing one in every five things it does today if taxes are to remain at their current level and promises to the elderly are kept.

- By 2030, the deficits in Medicare will claim one in every three general revenue dollars; by 2050, they will claim one in every two.

Most discussions of the future of Medicare assume the program will somehow get off of the current path, precisely because it is impossible. The Social Security and Medicare Trustees, for example, assume that the rate of growth of health care spending will gradually slow to match the rate of growth of national income over the next 75 years.

They do not say how this will happen. Yet even on this much rosier path, the future still looks bleak:

- The last Trustees report estimates the 75-year unfunded liability in Medicare at $36 trillion.

- Looking indefinitely into the future, the unfunded liability is $85.3 trillion — more than five times Social Security's unfunded liability, and five and a half times the size of the entire economy.

Medicare's Structure: Parts A, B and D.

- Medicare Part A pays for inpatient hospital care, skilled nursing, home health and hospice care; it is funded by a 2.9 percent payroll tax on wages and taxes collected on Social Security benefits.[1]

- Medicare Part B mainly pays physicians' fees; taxpayers fund three-fourths of the cost through general federal revenues and the remaining one-fourth is paid in premiums by retirees.

[1] Medicare Part A is already paying out more than it collects. The program has paid full benefits during that time because it is able to draw on general federal government revenues. In doing so, Medicare is technically drawing down past surpluses credited to a Trust Fund. This practice will continue until the Trust Fund is exhausted by 2017, at which time the program will only be able to pay what it collects in payroll taxes. These are legal and accounting issues that stem from the political desire to finance benefits over time with payroll taxes. The real pocket-book issue is: What programs and entitlement benefits will the federal government have to cut or what taxes will it have to raise in order to fund the cash flow deficits that have already emerged and will continue to grow catastrophically for as far as the eye can see? To see a more detailed discussion about how the Medicare Trust Fund works, see Thomas R. Saving, "Answering the Myths about Social Security," National Center for Policy Analysis, Brief Analysis No. 509, March 22, 2007.

- Medicare Part D is the newly-enacted prescription drug program; general revenues (that is, taxpayers) foot the bill for 86 percent of the cost and the rest is funded by seniors' premiums.

- Medicare Part A is already paying more in benefits than it receives in payroll tax revenues: Last year it ran a cash flow deficit of about $6 billion.

  - Technically, Medicare is drawing down past surpluses credited to a special Trust Fund. This practice will continue until the Trust Fund is exhausted by 2017, at which time the program will only be able to pay what it collects in payroll taxes.

  - These are legal and accounting issues that stem from the political desire to finance benefits over time with payroll taxes. The real pocket-book issue is: What programs and entitlement benefits will the federal government have to cut or what taxes will it have to raise in order to fund the cash flow deficits that have already emerged and will continue to grow catastrophically for as far as the eye can see?

- Total spending on Medicare-covered services totals more than $15,500 per beneficiary; however, beneficiaries pay less than one-third of the costs.

  - Medicare will pay for about 72 percent of this total (about $11,093) though beneficiaries will cover some of this amount through Part B and D premiums.

- Total spending on Medicare covered services from all sources (including private insurers and out-of-pocket spending) are estimated to be $15,257 per beneficiary in 2008.

- Of course, beneficiaries also purchase other services not covered by Medicare such as long term care and dental services that are not included in this calculation.

NCPA Policy Recommendations

- **Reform Medicare.** Overhaul the Medicare program by combining Medicare A, B & D, as well as individually-purchased Medigap plans, into a single plan with a single premium. Seniors should be able to choose from among competing plans in the private market with different features and options, just like nonseniors do today. In addition, encourage workers to save money today to fund future elderly health care benefits.

- **Help Seniors Save.** Allow Medicare-eligible seniors to open and make deposits to Health Savings Accounts (HSAs) to cover out-of-pocket health expenses; short of that, seniors should be able to turn IRA and 401(k) funds into Roth HSAs.

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