Testimony of Paul R. Huard
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of
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regarding
"The Impact of a Higher Retirement Age"

Summary

Although solvency of the Social Security retirement system might be achieved through increased retirement age, any such change would create substantial problems for employee benefit plans, to the detriment of a great number of individuals in the workforce. Moreover, the simplistic question of a uniform age for retirement rapidly becomes an obsolete consideration. An increasingly diverse workforce requires not uniformity, but flexibility. The only apparent means of providing individuals in the workforce with the flexibility necessary to retirement security is through personal accounts under a fundamentally reformed Social Security system. Although the NAM has not taken a position on the question of an increased Social Security retirement age, we address the questions asked by the Committee with reference to the experience of NAM members regarding employee benefit plans.

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Thank you Chairman Grassley. I am Paul Huard, Senior Vice President for Policy and Communications of the National Association of Manufacturers. I am pleased to represent the NAM today in testifying before this committee concerning the impact of a higher retirement age on solvency of the Social Security retirement system, and of the effects upon employees and employers.

This afternoon, I shall respectfully suggest that the committee direct its attention not to the question of a uniform retirement age, but rather, to policy that allows individuals increased flexibility as they plan for and approach their retirement.

The NAM

The National Association of Manufacturers is the oldest broad-based trade association in the nation. Founded over a hundred years ago, the NAM encompasses 14,000 member companies that account for 85-percent of goods manufactured in the United States. NAM members range in size from companies with fewer than 50 employees, to those with more than 100,000.

Because of the importance of the issue to member companies, the NAM became a leader among trade associations in addressing Social Security solvency and the need for reform of the current system. In 1995, the NAM formed a task force to examine the dimensions of the pending insolvency of Social Security, and to consider potential remedies. Last year, the task force presented its recommendations to the NAM Board of Directors, which approved a "Statement of Principles for Social Security Reform." To the best of our knowledge, the NAM was the first employer group in the country to reach such a consensus on the fundamental aspects of reform.

Employee Benefit Plans Sponsored by NAM Member Companies

The great majority of NAM members sponsor benefit plans that provide employees with retirement benefits, health care coverage, or other benefits, such as life insurance and disability coverage. Benefit

plans constitute a form of compensation to employees. As a consequence, each employer designs plans that best accommodate the needs of a particular group of employees. Thus, plan design and the mix of benefits offered vary widely. Such variety makes generalizations difficult. Regardless, the design consideration most nearly universal to all employee benefit plans is the overriding significance of normal retirement age ("NRA") under the Social Security system.

The NAM has not taken a position on the issue of an increased retirement age under Social Security. Moreover, the question raised by this Committee is not whether the NRA should be increased, but the effects of doing so. In this regard, we are pleased to make the following observations concerning the NRA, employer-sponsored benefit plans, and changes to the structure of Social Security.

The Social Security Retirement Age and Employee Benefit Plans

With respect to an archetypical defined benefit pension plan, the NRA marks the time at which an individual may retire with a "fully-accrued" benefit. Such a benefit is likely based on a combination of final average compensation and years of service with the employer. The normal form of benefit is a joint and survivor annuity for the retiring employee and his or her spouse.

In addition, the NRA serves as a factor in formulas that determine the level of benefits payable at an early retirement age ("ERA"). In this regard, most defined benefit plans provide for an actuarially reduced benefit, as a direct comparison to the benefit based on NRA.

(Defined benefit plans, in which a formula determines retirement payments, are the obverse of defined contribution plans. With the latter, annual employer contributions to an individual's account, plus accrued earnings, may be distributed at the time the individual reaches an age specified in the plan, frequently an age less than NRA or ERA.)

Separately and significantly, the NRA affects employers' cost of health care coverage for employees, and determines the design of post-retirement health care plans.

The Normal Retirement Age and Solvency of the Social Security System

The National Commission on Retirement Policy ("NCRP"), convened by the Center for Strategic and International Studies, after a year of intensive work, recommended an increase in the NRA and ERA. Warren Batts, former Chairman of the NAM, was pleased to serve on this bipartisan commission, chaired by House and Senate Republicans and Democrats, one of whom was Sen. Breaux, the ranking minority member of this Committee.

The NCRP released its conclusions in May. Under the NCRP proposal, such increases in NRA and ERA would prove largely responsible for restoration of long-term solvency to the Social Security retirement system, without the necessity of tax increases. The Commission determined, quite simply, that an increase in the NRA provides the single most effective means of reducing liabilities under Social Security, and thus proves most effective in restoring solvency to the system.

Although members showed concern for the issue during deliberations of the Commission, the NCRP did not specifically address the potential effects of increased NRA and ERA upon individuals. It seems appropriate that this Committee examine the issue carefully.

The Normal Retirement Age and Individuals in the Workforce

As others presenting testimony to this Committee are likely to note, the Social Security NRA remains, as always, arbitrary with respect to individuals. Age 65, or 67, or 70 may mean little or nothing with respect to whether a person is physically and mentally capable of continuing as a wage earner. The theory of "human depreciation" espoused more than half a century ago, assumed age 65 as the point of physical exhaustion. The theory may have had at least some value at that time, when labor usually meant strenuous physical activity. But work and the workforce have changed dramatically.

Some vocations remain toilsome, and physical strength, stamina and agility constitute prerequisites. Construction workers, firefighters, and oil well "roughnecks" come to mind. However, machine technology and electronics have altered the nature of work fundamentally. Physical capacity becomes far less significant than mental attributes. The technology-intensive workplace depends more upon problem solving, flexibility and imagination displayed by individuals.

The premium of the intellectual over the physical becomes obvious in modern manufacturing. Although physical stamina and agility continue important in certain trades on the shop floor, *mental* agility is of primary importance throughout the entire organization. The continuing value of individual workers is determined less by physical factors than by predisposition to remain actively engaged in performance of the daily effort.

As a consequence, employers find that employees increasingly treat retirement as a matter of individual choice. The physical is less a determinate than the mental. Individuals retire less because they *have* to, than because they *want* to. And increasingly, individuals want to retire earlier, not later.

Changing Assumptions about "Retirement"

At the time Social Security was enacted, and a decade later, as defined benefit plans became ubiquitous, two assumptions were in order.

First, an individual worked for a single employer for an extended number of years likely as not, 30. Secondly, at age 65, the worker was physically limited, so that "retirement" constituted a period of reduced activity. Social Security existed so as to supplement life savings and insure against poverty after the individual was unable to affect his economic situation. For the individual who had accrued the benefit during his extended working years with one employer, a pension provided deferred compensation in the form of a life annuity. Such a paradigm still exists, but has become remarkable for its novelty.

Although some persons in the workforce may actually become exhausted by age 65 (or 67 or 70), most are not. And if some choose traditional inactivity, most do not. In this regard, "retirement" increasingly becomes a means by which individuals pursue part-time or non-traditional vocations, outside the traditional norm.

Moreover, fewer individuals spend an extended portion of their working lives with a single employer. Thus, fewer enjoy a pension benefit sufficient in itself to subsidize an inactive retirement. The emerging pattern is cash-out of any accrued pension benefits in a lump sum. Such an amount, plus retirement savings through defined contribution plans or Individual Retirement Accounts, provide the means by which individuals pursue a new vocation or non-traditional activities in advance of the "normal" retirement age as defined by Social Security.

Thus, in the new paradigm, "retirement" means voluntary termination of employment, perhaps a decade or more before NRA, and the individual's continued participation elsewhere in the workforce for an

indefinite period. Anecdotal evidence suggests that the experience of manufacturers is little different than for employers in other sectors of the economy. It clearly appears that if individuals have accumulated substantial retirement savings, through a traditional pension plan or otherwise, they are likely to elect early "retirement."

The new paradigm is encouraged by another great change in the workforce: Two-earner families. Both such spouses may have accumulated deferred compensation though pension plans or retirement savings vehicles. One spouse may remain actively engaged in the tenured vocation while the other "retires" to a new occupation or non-traditional activities. For such persons, like others noted above, the Social Security normal retirement age represents little more than an accounting function. A uniform retirement age becomes increasingly irrelevant in a non-uniform workplace and a non-traditional economy. Individuals need *flexibility,* not uniformity.

Potential Effects of Increased Retirement Age on Benefit Plans and Individuals

As noted above, employee benefit plans are unique to employers and to groups of employees. Thus, such plans can provide necessary flexibility to accommodate changes in the workforce and the economy.

The availability of early retirement provisions under defined benefit plans (sometimes combined with bonus retirement points) has encouraged individuals to retire as a matter of choice rather than necessity. To a similar effect, 401(k) plans and other defined contribution vehicles have provided both the funds and flexibility to allow early exit from an organization, for reasons unique to each employee so choosing. An increased NRA would limit such flexibility.

(Although the ERA might remain age 62 with any increase in the NRA, the following discussion assumes that NRA and ERA would increase in tandem.)

The "normal" retirement age under Social Security, whatever the number of years, will continue to have an immediate effect upon the design of employer-sponsored retirement plans. This is a consequence of the widespread practice of "integrating" retirement benefits under qualified plans with benefits under Social Security. (The term that describes integration according to technical tax rules is "permitted disparity." The following discussion refers to integration in a generic sense.)

Under integration, the pension benefit accrued, and the contributions to certain defined contribution plans, are offset by the retirement benefit an individual receives from Social Security. Thus, the benefit under the pension plan, beginning at NRA, is reduced by the Social Security benefit. Such a reduction reflects the fact that employers have paid payroll taxes through which a nominal half the Social Security benefit is funded.

However, if an employer offers an early retirement benefit (beginning before eligibility for Social Security) the plan may pay the equivalent of the Social Security benefit as a subsidy until the former employee attains NRA. An employer may find it economically feasible to provide such a deemed Social Security benefit for a five-year period (between age 60 and 65). However, an increase in the NRA to age 70 would double the cost of the subsidy. Thus, employers would be less likely to adopt such a provision, to the detriment of employees. Much of the flexibility gained through early retirement provisions would be lost as a consequence.

Separately, an increased NRA would cause a correspondingly greater actuarial reduction of pension benefits, dramatic in the case of *earlier* early retirees. In order to continue benefit integration, employers would raise "normal" retirement age under pension plans to correspond to an increased Social Security

NRA. For individuals in early or mid 50's, the greater actuarial discount from the new normal age under the plan would reduce the pension benefit more steeply, regardless of whether an employer provided a deemed Social Security benefit as a subsidy. An increase in the Social Security NRA would affect other benefit plans as well.

The cost of long-term disability plans would increase, because such plans typically provide benefits until a disabled individual reaches ERA. As noted, we assume that an increase in ERA would follow in tandem with an increased NRA. Thus, the plan sponsor would be liable for disability benefits over a greater number of years, with an increase in plan costs as a consequence. The costs would appear as increased premiums by employers (and employees as well, in typical plans) for disability coverage.

Finally, an increase in the NRA would raise the cost of employer-provided health care substantially. To the extent that the higher NRA, though the effect on benefit plans and otherwise, encouraged delayed retirement, the costs of health care would increase to reflect a correspondingly older population of employees. And if an employer provided post-retirement medical coverage for early retirees, such costs would increase as well. Such plans typically provide benefits until early retirees become eligible for Medicare. The higher NRA, equivalent one supposes to an increased Medicare eligibility age, would mean a longer period of coverage and an older, correspondingly less healthy, retiree population.

Thus, an increased NRA would increase the costs of employee benefit plans substantially, discouraging employers from offering the range and value of benefits currently available. As a consequence, both employers and employees alike would lose much of the flexibility that make plans valuable under early retirement programs and otherwise.

Individual Retirement Accounts as a Means of Enhancing Flexibility for Individuals

Through the information set out above, we have responded to the questions specifically asked by the Committee effects on Social Security solvency and upon individuals through an increased retirement age. For reasons noted, such an increase appears detrimental to the *flexibility* which most individuals seek in planning for and approaching retirement. In conclusion, we suggest that much of the lost flexibility could be regained though substantial reliance on a system of personal retirement accounts under a fundamentally reformed Social Security system.

Personal accounts, repositories of the retirement savings of a lifetime, would offer all individuals in the workforce a degree of flexibility similar to early retirement programs and the defined contribution plans discussed above. Such accounts would give all persons the opportunity to tailor "retirement" to personal preference and changing circumstance. In this regard, such accounts would prove increasingly appropriate to a more diverse workforce and complex national economy.

The twin assumptions of long tenure with a single employer and terminal physical ability at a uniform age will continue to erode. Traditional defined benefit plans will continue as a means for a significant portion of the workforce to accomplish retirement income security through accrual of annuities. But increasingly, such defined benefit plans are assumed limited to large "institutional" employers. Historically, such employees are less mobile than for the workforce at large, so that accrual of substantial retirement benefits is a more realistic assumption.

But even traditional plans begin to assume more of the features common to defined contribution plans lump sum payment of accrued benefits, "cash balance" features, and early retirement options. That defined benefit plans mimic individual account plans suggests that the latter type of plan, with its greater flexibility and more "personal" features, is increasingly the retirement vehicle of choice for individuals

in a changing workforce.

As this Committee is well aware, Social Security is a defined benefit plan. Like employer-sponsored pension plans, Social Security provides benefits based on an individual's earnings history, payable in annuity form. If employer-sponsored defined benefit plans are proving less effective in meeting the needs of individuals, it seems obvious that the same would be true of the current Social Security system.

In this regard Chairman Grassley, rather than seeking to establish the "correct" retirement age, the Committee might examine the issues of an aging population in the context of individual choice and flexibility. And if it does so, we suggest that the Committee is likely to conclude that personal retirement accounts, analogous to employer-sponsored defined contribution plans, should provide the principal retirement benefits under a fundamentally reformed Social Security system.