

## Executive Summary

The “three-legged stool” metaphor for retirement has outlasted its usefulness. Social Security, while under threat from predicted shortfalls, can be solidified with relatively minor changes. Corporate defined benefit pensions are going the way of the dinosaur, and should not be saved. Private saving, whether independent or within government-subsidized programs like the 401(k) and IRA, will have to pick up the slack.

We lay out the problems with Social Security and private saving, take stock of what’s been done up to this point, and make common-sense proposals for reform. Social Security’s fiscal shortcomings can be more than erased by indexing the monthly benefit to account for increasing life expectancy, lifting the cap on earnings that are subject to payroll taxes, and dedicating the estate tax to the program’s legacy costs. For private saving, the 401(k) program serves as the framework for our more robust vision: a tax-preferred program where retirement accounts are tied to workers, not corporations, and employers must contribute to their employees’ well-being in their later years. We delve into the numbers, showing that in 2009 dollars, our plan would provide even a nontraditional employee a dependable income stream that would supplement Social Security benefits and provide a measure of financial security until death.

We close with an analysis of the political reality and a roadmap for our reforms. Policymakers must summon the courage to act, but we cannot make demands until our generation is inspired; our final proposal is to educate young adults – those that stand to gain the most by enactment of our reforms.

## **Breathing New Life into a Moribund Retirement Policy**

### **What is the problem?**

Traditionally, the strategy for retirement in America has been referred to as a "three-legged stool" (U.S. Senate, 1994). The three "legs" are Social Security, a corporate or other defined benefit pension, and personal savings. Unfortunately each leg is wobbling. The Social Security program faces a budget shortfall by 2042 (Diamond & Orszag, 2004), after which it is projected to be able to pay out 75% of promised benefits to retirees. Corporate pensions appear to be a thing of the past (PBGC, 2009), quickly being replaced by government-incentivized private pension plans like the now-familiar 401(k) - new workers cannot expect their employers to provide a monthly annuity after they retire. Finally, Americans' private savings rate reached an all time low in 2008 at less than 1%, and the past two years have seen only modest improvements ("Series: PSAVERT," n.d.).

### **Social Security: The easiest leg to fix**

Signed into law in 1935, the Social Security program was an answer to a specific question: in the context of the Great Depression, how could our society prevent its oldest citizens from living in poverty? As Senator Robert Wagner (D-NY) put it at the time, federal old age annuities represented "the final tower of strength in a fortress against destitution in the winter years of life" (U.S. Senate, 1935, p. 9). Part of Franklin Roosevelt's New Deal, the program came under fire almost immediately - although critics ranged from economists to the NAACP ("Social Security," n.d.), its toughest test came in the form of constitutional challenges. Many New Deal programs were struck down by the Supreme Court as outside of the federal government's power. Only after Roosevelt put forward his widely criticized plan to add six more justices did the Court begin to uphold significant parts of Roosevelt's agenda.

In 1937 the Supreme Court upheld the Social Security program with *Steward Machine Company v. Davis*, in which the majority opinion declared that "It is too late today for the argument to be heard with tolerance that in a crisis so extreme the use of the moneys of the nation to relieve the unemployed and their dependents is a use for any purpose narrower than the promotion of the general welfare." Since the new federal payroll tax could not be ruled coercive - each state retained the ultimate choice over whether or not to comply with an unemployment insurance program instead of paying the federal tax - the new "excise" on payroll could be upheld in agreement with Article I of the Constitution ("Social Security history," n.d.).

Although many attempts have been made to bolster the financial position of Social Security since its inception, the experience of the program's first retirement beneficiary portended its recurrent problems: Ida May Fuller lived to be 100 and collected benefits for 35 years ("Details of Ida," n.d.). Members of our generation can expect to live longer than those of any that have come before it, and this prospect

threatens the program's solvency. Both dimensions of the Social Security problem are addressed below.

### **Corporate pensions: The disappearing leg**

Corporate pensions are so-called "defined benefit" programs, in which a corporation invests money over long periods of time in order to pay pre-determined benefits to retirees on a monthly basis (an annuity) throughout their retirement. These programs came into fashion along with and as a result of better labor organization and widespread collective bargaining in the first half of the 20th century, the predictable annuity payments from defined benefit pensions have provided a relatively worry-free retirement experience for generations of Americans. Unfortunately, these pensions proved to be mismanaged and sometimes too large an obligation for individual corporations to bear (Maynard, 2004).

As companies like United Airlines and Delphi Corporation have gone through bankruptcy, they have divested themselves of their pension plans and turned them over to the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a government corporation chartered in 1974 as part of the Employee Retirement Income Security Act (ERISA). PBGC acts as an insurer of single-employer and multi-employer defined benefit plans, and in the event of a plan's termination, it provides partial benefit payments to beneficiaries (PBGC, 2009, p. 1).

Corporate pensions have become less numerous and dangerously underfunded over the last decade. Since the 1960s, the proportion of private-sector employees covered by defined benefit plans has decreased from 60 percent to 18 percent (Lowenstein, 2008, pp. 225-226). As employers with defined benefit plans terminate them in bankruptcy and new companies choose to offer defined contribution (401(k)) plans instead, the pool of pensions the PBGC insures gets weaker and weaker; in 2009 alone, 144 defined benefit plans were terminated and PBGC's deficit ballooned from \$11 billion to \$22 billion (PBGC, 2009, p. 4). Between 2007 and 2009, the number of pension plans guaranteed by PBGC declined by almost 5% (PBGC, 2007, p. 1; PBGC, 2009, p. 1). Despite repeated efforts to stem the tide, PBGC's financial position - as well as that of many individual pension plans - has continued to deteriorate.

Defined-benefit pensions are products of voluntary agreements between employers and (often organized) employees. They are not the result of state or federal government mandates. Changes in the economic and political environment have made these programs considerably less desirable than they once were, and, we expect that traditional corporate pensions will continue to wither both in number and in the role they play in the American retirement experience. We offer no prescriptions to avoid this.

### **The 401(k): Private saving or corporate pension?**

The slow death of the corporate pension has been accompanied by a dramatic expansion in corporate participation in 401(k)-style plans. A 401(k) - named for the line in the Internal Revenue Code, which permits them - is a form of deferred compensation with origins in the Revenue Act of 1978. The first large corporate 401(k) plans started in January 1982, and by 1984 401(k) plans had more than seven million individual

participants. Twenty years later, these pre-tax deferred compensation vehicles held assets of nearly \$2 trillion (EBRI, 2005).

These plans are far from perfect. 401(k)s have limited access – there are exemptions for non-full-time employees, as well as for temporary and migrant workers. These exemptions make such plans inaccessible for many low-income wage-earners. Another issue with the 401(k) program is that it is linked to the employer who is contributing to it. An employee either must find a new job that offers a 401(k) plan in order to maintain a tax-advantaged status for the funds, or must "roll over" the funds into an IRA (Individual Retirement Arrangement). This process often leads to the employee losing a portion of retirement savings to the fees involved in transferring the account.

The recent recession has highlighted another challenge to 401(k) plans. Employer contributions have broadly declined, with some companies no longer contributing to employee savings at all. This is also indicative of a larger trend of businesses trimming employee benefits before other costs.

### **Private saving: An underutilized source of retirement security**

The third "leg" of retirement, personal saving, is also in trouble. America's personal savings rate, as a percentage of disposable income, hovered below 1% as recently as April 2008 - down from a modern high of 12.2% in 1981 ("Series: PSAVERT," n.d.). Saving has rebounded recently - the rate stood at 4.4% in October 2009, but perhaps of more concern is that for more than 30 years, increases in personal saving have only occurred during recessions. It seems that under the *status quo*, our only hope for greater personal saving is a bad economy.

The decline in personal saving has occurred during one of the longest periods of economic growth in our nation's history. It also has coincided with some of the federal government's most innovative attempts to encourage private saving. In addition, to the 401(k) program, the government has created a number of other financial incentives for individuals to create long-term savings. The best-known of these are tax-advantaged investment vehicles known as Individual Retirement Accounts (IRAs). The most common types are the traditional back-loaded IRA and the front-loaded Roth IRA. IRAs share many of the problems of all private investments, however. The volatility of the market remains a large concern, as well as the diversity and strength of investments chosen by individual savers. IRAs can contain conservative or riskier investments, with the riskier investments typically adding the most value – when they are successful.

Personal saving is a hard target for Congress to hit. The economic decisions of individuals are influenced by countless factors, including Social Security. Public pensions like Social Security have been found to discourage private individual saving across most of the income spectrum (Attanasio & Rohwedder, 2003; Feldstein, 1974). Furthermore, requirements that most personal assets must be liquidated before an individual is eligible for many important government assistance programs (e.g., Medicaid) creates a disincentive to the poor to save anything at all (Smith & Rand, 1995).

## **The aging of America: Our biggest challenge?**

On top of the problems with our retirement savings system presently, America faces a new challenge: sweeping demographic change. As fertility rates drop and life expectancy increases, the population as a whole in the industrialized world will become older. According to the United Nations, "...the population aged 60 or over is expected nearly to double (from 245 million in 2005 to 406 million in 2050) whereas that of persons under age 60 will likely decline" (United Nations, 2006, p. vii). This demographic shift will impose new financial burdens on the old-age entitlement programs of the developed world. In the United States, for example, as a higher proportion of the population reaches the age of 65 (and 67), more money will have to be obtained from fewer workers for Social Security and Medicare. The Global Aging Initiative goes further; they predict that the aging of developed nations like ours will result in a sustained decrease in the growth of GDP, and possibly a "no growth" economic cycle (CSIS, 2008).

These are the problems in a nutshell. What are we going to do about them? In the next two sections we go into more detail on the specific problems facing Social Security and private saving for retirement, and offer policy solutions for both. In the final section below, we take stock of the politics of reform.

### **How do we stabilize Social Security?**

Social Security's stability can be ensured by making adjustments in revenue (the money going into the program's trust fund), in benefits paid to retirees, or a combination of both. Policy experts have proposed and evaluated many options meant to solve all or part of the system's financial problems. The National Academy of Social Insurance (NASI), for example, recently released *Fixing Social Security: Adequate Benefits, Adequate Financing* (2009) which listed thirty options for improving Social Security's finances proposed by various individuals and organizations, and ten ways that benefits could be enhanced to better support beneficiaries. Below, we choose three specific reforms from among them. We believe that these reforms are easy to understand, and will stabilize Social Security financially while treating workers and retirees fairly. First, however, we criticize two categories of reforms which we believe will not work well: raising the retirement age and privatizing Social Security. Next we make our case for adjustments for life expectancy and growing income inequality in the United States, and the legacy costs of the Social Security system itself.

### **What doesn't work for Social Security?**

#### *Would raising the retirement age fix Social Security?*

Longer life expectancies contribute to Social Security's projected deficit, prompting some analysts to argue for raising the retirement age to mitigate the impending

shortfall. We do not agree with this approach, and offer below our explanation as to why this is not a viable option. Our proposal is to eliminate Social Security's long-term deficit by addressing the ebb and flow of changes in life expectancy, instead of by assigning an arbitrary age to retirement.

Existing proposals that NASI (2009) identified for increasing the age for full retirement benefits are: 1) Accelerate the increase to 67 and then increase the full benefit age by one month every two years to age 68; or 2) Accelerate the increase to 67 and then increase the full-benefit age by one month every two years to age 70; or 3) Gradually index the full-benefit age for longevity indefinitely.

The first of these options would eliminate just under one fourth of the long-term deficit, but only by reducing by a third the retirement benefits of those retiring at age 62. The second option, raising the retirement age to 70, would reduce the long-term deficit by less than a third, but those who opt to retire at 62 would have benefits reduced by 43%. The third option would eliminate only about one sixth of the long-term shortfall. Furthermore, continuous indexing would result in inconsistent cuts in benefits for those taking early retirement (NASI, 2009).

More generally, increasing the full retirement age (currently at age 67 for people born after 1960; Social Security Administration, 2009) would profoundly and differentially affect entire segments of the labor force. For example, people who have worked in manual labor throughout their careers cannot work as long as counterparts who have less physically demanding jobs. A retirement age increase would unfairly penalize many hard-working Americans who take the early retirement option due to the physical demands of their jobs.

As NASI underscores, Social Security's "full-benefit age of 67 is already older than eligibility ages in private pension plans, which remain 65 or earlier," and 67 is also greater than the age at which retirees can draw, penalty-free, from their 401(k)s or IRA accounts (NASI, 2009). Raising the Social Security retirement age would further exacerbate the problem of the "three-legged stool" model by maintaining a disparity between the retirement ages for Social Security, defined benefit pensions, and private savings. While many Americans could potentially adjust, a new penalty on workers forced to take early retirement is not part of our ultimate goal of improving Social Security.

### *What about privatizing Social Security?*

Privatizing Social Security is an idea that has gained momentum on the political agenda over the past few years. Two different types of privatization have been proposed: investing a portion of the Social Security trust fund in the stock market, and creating individual accounts.

Currently the trust fund is invested in Treasury bonds and not in the stock market. Treasury bonds carry almost no risk, but offer a low rate of return. Proponents of privatizing Social Security would have the government invest part of the trust fund in equities (stocks). Under this plan, the rate of return depends on the performance of the stock market. This would be risky for a defined-benefit system like Social Security, which currently spreads risk across a broader population and allows time for adjustment for many generations – not just "those holding the assets and nearing retirement"

(Diamond & Orszag, 2005).

Distortions in the allocation of resources in capital markets is a significant concern voiced by those opposed to Social Security privatization. As Alan Greenspan said, “even with Herculean efforts, I doubt if it would be feasible to insulate, over the long run, the trust funds from political pressures—direct and indirect—to allocate capital to less than its most productive use” (Kaplan & Zelermyer, 1999). Consider for example the likely political debate over the possibility of investment of some of the Social Security trust fund in tobacco stocks. Another issue might be other possible governmental conflicts of interest such as the enforcement of antitrust policy. A triumph over a behemoth such as Microsoft could result in stock price decreases costing retirees millions or even billions of dollars.

A more aggressive form of Social Security privatization would be the substitution of individual accounts in lieu of workers’ FICA payments to the government, with a substantial part of those accounts invested in the stock market (Weller, 2006). This idea received a lot of attention early in George W. Bush’s second term. The main argument in favor of this model is that it would allow individual retirees more flexibility in saving for their future.

Diamond and Orszag (2005), on the other hand, view individual accounts as “inappropriate for a social insurance system intended to provide for the basic tier of income during retirement, disability, and other times of need” (p. 133). They offer a case for why individual accounts would not work. Their central argument is that creating individual accounts would only decrease the deficit if linked to a reduction of benefits (Diamond & Orszag, 2005). In fact, if individual accounts were funded through the allocation of revenue away from the Social Security trust fund, it would in effect *increase* the deficit.

A second set of arguments against this proposal focuses on the macroeconomic repercussions of replacing Social Security with individual accounts. These accounts could affect the entire economy through national saving, work effort, and aggregate risk taking (Diamond & Orszag, 2005). Under the status quo, changes in the Social Security surpluses “do not necessarily result in large changes in the non-Social Security deficits of the federal government” (Diamond and Orszag, 2005). Thus, individual accounts could actually reduce national savings. Others have argued that the creation of individual accounts would increase work effort. This seems unlikely, however, because young individuals tend not to pay as much attention to retirement, let alone Social Security, as older people. As a result, the work effort by younger generations is unlikely to change, offsetting any labor supply effects. Finally, aggregate risk taking causes little change in the economy due to the counteracting balance between demands for stocks and increased interest rates for government bonds. As a result, “individual accounts would likely not generate any significant gains in overall economic efficiency” (Diamond & Orszag, 2005).

George W. Bush tried mightily during his time in office to move Social Security toward reliance on individual accounts. However, no legislation was passed and the measure quietly disappeared from the active agenda within a mere ten months (Nuschler, 2009). It disappeared because both parties recognized it as obscenely expensive and as not providing a solution to the expected trust fund shortfall.

A third argument against privatizing Social Security with individual accounts

focuses on the jeopardy in which market risk places individual prospective retirees. Market risk can be illustrated by setting the average rate of working life at 35 years. If a market, over that 35 year period, has low rates of return, then workers during that period retire with less money than those who work during robust financial times. Personal saving outside Social Security is often posited as a way to offset market risk. Weller (2006) counters with the argument that those most affected by market risk rely disproportionately on Social Security and are often the same people who rely on it exclusively to fund their retirement. Saving outside of Social Security is not feasible for people without the means.

A fourth argument against privatizing Social Security is that there would be a vast difference in the performance of workers' investment funds, creating situations in which workers begin retiring with far less than they anticipated, much like what has occurred with individuals managing their own 401k(s). Weller (2006) points to the British pension system as a harbinger of what could happen if the United States moved to privatize Social Security. Under Margaret Thatcher's administration, the British pension system was partially privatized, but large holes in pension adequacy surfaced two decades later. This is particularly relevant to privatizing Social Security because the British system was one of the first encounters with public pension privatization in an industrialized economy.

While privatizing Social Security sounds appealing to some, analysts have thus identified significant problems with this proposal. It would not help decrease the deficit and would most likely increase it, major macroeconomic repercussions would reverberate as a result of these reforms, market risk is too great, and it would result in disparity among workers' individual accounts and increase in the proportion of elderly living in poverty.

### **Why change one of America's most successful government programs?**

If we measure the Social Security program based upon its original intent – to serve as a “tower of strength in a fortress against destitution” (U.S. Senate, 1935, p. 9) – it has been a success. The program has helped millions of Americans avoid poverty upon approaching old age, becoming disabled, or after the death of a family wage earner (Diamond & Orszag, 2004).

However Social Security is in a quiet crisis. The trust fund from which benefits are paid – the “OASI” trust fund – faces a long-term deficit because demographic shifts have not been acknowledged with program changes. According to the 2009 Trustees Report, excess balances built in the trust fund since 1983 – the last time the program was reformed – will be exhausted in about 2037. At that point, current income to the trust fund, given current tax rates, will be able to pay only about 75% of the benefit retirees expect under today's formulas. This is a clarion call to those who wish to save Social Security because they recognize the program as a vital component of our social safety net in times of trial and prosperity. Despite the fact that numerous proposals have been advanced to fix this looming crisis, political divisiveness has stymied progress. It is within this political climate that we urge critical reforms to Social Security to ensure its solvency for future generations. The key to our proposal's success is to implement reform

swiftly and directly, by garnering political will, in order to distribute the positive effects of reform gradually over generations of beneficiaries.

### **How does Social Security work?**

Social Security provides recipients “with a well-defined, assured basic income that is protected against inflation, the risk of outliving one’s assets, and financial market fluctuations” (Diamond, & Orszag, 2004, p.25). It is progressive in that it replaces a larger portion of wages for those who had lower incomes than for those whose earnings were high during their working lives. The success of the program is contingent on its ability to do these things without “breaking the bank.”

### **What should we do to ensure that Social Security works moving forward?**

Though changing Social Security is perhaps politically difficult, there are straightforward and primarily technical mechanisms that could fill the gap in trust fund revenues. Our proposal for reforming Social Security includes three such components: adjustments for life expectancy, adjustments for increasing earnings inequality, and adjustments for legacy costs.

#### *Adjustments for life expectancy*

The first component of our plan recognizes that life expectancy has risen, putting more pressure on the costs of Social Security. The current formula for calculating the monthly benefit does not account for increasing life expectancy and keeps paying out for more years as retirees live longer. It is clear that as medical advances allow humans to achieve older age, the future of Social Security is dependent on an adjustment to this formula. Accordingly, we propose a life expectancy adjustment be added to the formula for calculating the initial benefit; we recognize that the initial benefit will be reduced as life expectancy increases. This is critical toward the goal of buttressing Social Security. We would set a minimum benefit level at the poverty line to ensure that low-income retirees do not fall below it.

Including an adjustment for life expectancy will allow for responses to changes in life expectancy over the duration of the program. Our approach is modeled on Diamond and Orszag’s (2005) preferred adjustment structure, which would “automatically adjust Social Security each year based on contemporaneous projections of life expectancy, rather than on life expectancy projections calculated today” (p. 82). The Office of the Chief Actuary should compare the “cost of benefits for different cohorts, using successive mortality tables... Half of this ‘net cost of increased life expectancy’ would be offset by a reduction in [initial monthly benefit], which would apply to all covered workers age 59 and younger” (Diamond & Orszag, 2005, p. 83). This would ensure that once a worker reaches the age of 60, her foreseeable benefits would be solidified, regardless of life expectancy fluctuations.

Our proposal rejects the option of raising the retirement age because we view it as unfair, and because it is not needed to achieve actuarial balance in the program. A worker decides when to retire based on many factors, in addition to life expectancy, and our plan

accommodates that individual calculus. The enactment of this proposal will reduce the seventy-five-year actuarial deficit by “slightly less than a third of the currently projected deficit” (Diamond & Orszag, 2005, p. 84).

#### *Adjustments for earnings inequality*

The second component of our plan for shoring up Social Security confronts the growing income disparity in the U.S. Higher income workers in the U.S. are capturing an increasing share of total annual income in the economy. Currently, 17 % of the population earns above \$106,800 per year, but the payroll tax is not levied on earnings above that amount. This represents a decline in the percentage of all earnings taxed for Social Security from 90 percent in 2005 to 83 percent in 2009 (Board of Trustees, 2009), meaning that we are trying to pay Social Security benefits by taxing a smaller base. This problem is compounded by increasing life expectancies enjoyed by high-income workers. These workers will draw benefits for longer periods based on taxes paid by lower income workers. Combined with our adjustments to life-expectancy, removing the cap on taxable income will mitigate this profound unfairness and help address the future insolvency of Social Security.

Our plan will eliminate the cap and continue to count earnings toward benefits, but to negate the potential for very high benefits, which could impose an unbearable strain on Social Security, we propose that the benefit formula be changed to “replace a smaller portion of earnings above the [current] cap” (NASI, 2009). According to NASI (2009), Social Security distributes benefits based on a formula that includes the following three brackets:

1. 90 percent of worker’s average indexed monthly earnings (AIME) up to \$744, plus
2. 32 percent of AIME between \$744 and \$4,482, plus
3. 15 percent of AIME over \$4,482.

A flatter formula evaluated by NASI (2009) would alter the third part of the above formula to 15 percent of AIME between \$4,482 and \$8,900 (\$106,800 divided by 12), plus 3 percent of AIME over \$8,900.

Should this formula be implemented in 2010, NASI (2009) estimates that the 75-year deficit would be eliminated, with a savings of 2.17 percent of payroll.

#### *Adjustments for legacy costs*

The third component of our comprehensive plan to strengthen Social Security is to address the legacy cost, the historical allocation of benefits to early beneficiaries who did not contribute as much as they received. Our primary conduit for offsetting this debt is the estate tax, a device suggested by Diamond and Orszag (2004) and Robert M. Ball (2007). The justification for utilizing a measure not attached to benefits is that the transference of a large estate should be required to contribute to the common good in order to be democratic (NASI, 2009). As the estate is in some ways derived from the

American workforce, the beneficiaries of large concentrations of wealth should contribute a tax for the common good.

*Will our plan achieve solvency for Social Security?*

Our plan is a common sense approach that recognizes the need to respond to change by making adjustments for increasing life expectancy, earnings inequality, and legacy costs. It restores solvency to Social Security through both revenue increases and benefit reductions. The current annual deficit in trust fund revenue amounts to 2% of taxable payroll (NASI, 2009). The following chart shows the extent to which each of our proposals addresses the shortfall.

### Summary of Proposed Social Security Reforms

Description of reform	Revenue as percent of taxable payroll	Percent decrease in trust fund shortfall
Index benefit to life expectancy	0.55	28
Remove cap on earnings taxed; calculate benefit with flatter formula	2.17	108
Dedicate estate tax to SS	0.51	26

Source: Social Security Administration, Office of the Chief Actuary, cited in National Academy of Social Insurance. (2009). *Fixing Social Security*. Washington, D.C.: National Academy of Social Insurance.

*What can we learn from other countries?*

According to the GAO (2008), other countries offer models for the U.S., demonstrating that entitlement program reform is possible, though difficult. Our benefit reduction proposals are inspired by successful reforms in other countries. According to the GAO (2008, p. 11), “since the early 1990s, almost all of the 30 [Organisation for Economic Co-Operation and Development] countries have restructured their pension programs, with a clear trend toward reduced benefits.”

All too often, gradual effects do not inspire urgency. The public does not recognize problems that come about over time. Rather, some discrete trigger, such as an economic crisis like the current recession or other pressure on the system, is necessary to generate sufficient public concern to initiate fundamental change. It is imperative that reforms to the largest single program in the federal budget, Social Security, are enacted before it has deleterious effects on our economy. The time to take action is now, amidst abounding economic disruption. If we take these steps toward recognizing the flaws in Social Security, the public will be ensured a foundation for future prosperity.

Other countries provide examples. “In the early 1990s, for example, the Swedish pension reform process took on urgency as Sweden experienced its worst recession since the 1930s” (GAO, 2008, p. 9). Other factors such as demographic change, a perception of declining economic competitiveness, or an uncertain political environment, can also act as catalysts for fundamental reform of the retirement system. Other countries’ successes offer some optimism for such reform. According to the GAO (2008, p. 12): “... pension reforms in Italy, Sweden, France, Austria, Denmark, and Germany ...

contributed to increased sustainability of public finances.” There is no reason to suspect that if our plan is enacted, we cannot realize increased fiscal security as well.

### **What about private saving for retirement?**

Currently, government efforts to incentivize private savings are encapsulated in the 401(k), the 403(b), and the Individual Retirement Arrangement (IRA). Through these programs, policymakers have attempted to convince workers to save more on their own, specifically for retirement; stiff penalties and a lack of tax-exempt status are imposed for early withdrawal.

### **What are the problems with private saving for retirement?**

The 401(k) program is a tax-sheltered savings program for earned income offered by many employers. Any private sector employer may offer the program, and any common-law employee of the employer is eligible to participate. Income may be contributed up to a certain limit without being taxed, and earnings on the contribution are also allowed to grow tax-free. The money, once in the 401(k), may be invested in many different instruments. Employees are typically offered a buffet of mutual funds in which to invest their savings.

In principle, the 401(k) program is highly beneficial to workers. They may save a large portion of their earnings in this tax-advantaged fund, and invest those funds in numerous investment vehicles. Not only does the employee receive a tax incentive for saving, but the employer may also contribute to the fund on a matching basis; this provides further incentive to save through what amounts to free money.

In reality, however, the 401(k) program can be ineffective if it is not managed in a skillful and proficient manner. As an example of poor fund management, many individuals believe that they can borrow from their 401(k) accounts without seriously affecting the amount of money they will have for retirement, so long as the borrowed funds are repaid in a timely fashion. This is not so. Borrowing from a 401(k) can severely reduce retirement resources. For instance, with a starting balance of \$50,000 and assuming an 8% growth rate, borrowing \$10,000 and repaying it over five years will reduce the balance of the 401(k) after 25 years by about \$98,000 compared to what it would be without the loan occurring (Mackell, 2008, p. xxi).

There are stiff penalties for early withdrawal from a 401(k). For instance, there is a 10% additional tax for taking distributions before the age of 59.5 (IRS, *Topic 424 - 401(k) plans*). These penalties are meant as a strong disincentive to meddle with retirement funding. The importance of letting funds accumulate interest cannot be overstated in the discussion on retirement savings. This dynamic can be interrupted by a change of employment; workers often have to pay fees to transfer funds from one employer’s 401(k) to another’s.

403(b)s are tax-sheltered savings plans similar to 401(k)s, although there are differences in which employers may offer plans and which employees may participate. 403(b)s may be offered by public education institutions and 501(c)(3) non-profit organizations. Employees of those eligible providers may participate in these programs (IRS, *IRC 403(b) Tax-Sheltered Annuity Plans*).

401(k) and 403(b) plans share common problems. Both require employees to choose how to invest their money. The advent of 401(k) plans greatly increased individual autonomy over retirement decisions, and this was touted as a major advantage of the approach initially. However, few people have the necessary knowledge to make informed monetary decisions

The 401(k) program has also encountered additional problems as of late, in that providers of 401(k)s are no longer making contributions at the levels they used to (Woodyard, 2009). This is largely a result of the current economic recession, which is causing companies to find cost-saving measures. However, this is also indicative of the larger trend in retirement funding today: whether the plan is a 401(k), 403(b), or IRA, the volatility of financial markets is a primary concern. The recent stock market crash and the ensuing economic crisis brought home the consequences of volatility. In a system that includes such vagaries as *quid pro quo* arrangements between rating agencies and security vendors, novice investors unable or unwilling to judge the trustworthiness of alternative investments can suffer.

### **A light at the end of the tunnel**

The problems of the 401(k) program as it exists are extensive, and have been detailed already. In order to ensure a secure retirement for Americans, reform must be undertaken in this area. Something like Hillary Clinton's proposed reforms to the 401(k) program will have to be implemented (Bombardieri, 2007). Perhaps the most important reform that could be undertaken in the 401(k) program would be to provide for accounts that are attached to individual workers rather than to their employers. We elaborate on this proposal below.

In addition to creating a more individual-centered account, a second reform that would serve the public interest would be a mandate for all employers to contribute to their employees' 401(k) accounts, whether those workers are full-time or part-time. In conjunction with individually controlled 401(k) plans, this would mean that individuals who work at more than one job – as part-time workers often do – could have multiple employers contribute to the same retirement fund. Currently, many employers do not offer their part-time employees 401(k) plans (Geller, 2007) for a variety of reasons, most of which would be resolved if the 401(k) were attached to the individual and not the employer. This could significantly benefit low-income individuals and families who are at increased risk for living in poverty in their old age.

A lack of education regarding the market environment may also be contributing to the unpreparedness and inadequacy of savings for many retired Americans. Most workers who participate in 401(k) programs do not work in the financial sector. These employees may work jobs that are entirely unrelated to finance, such as construction or manufacturing. Companies assume too much when they expect their employees to be able to safeguard their retirement with a minimal amount of guidance from financial experts.

To have a secure retirement, American workers need to be educated regarding investment strategy. They ought to be taught when it is advantageous to invest in stocks, and when to sell stocks and secure more dependable investment options, such as bonds. Education on how to diversify a portfolio, make sound investments, and strategy in a

financial crisis (such as the recent stock market crash) is critical for intelligent investment.

### **Our proposal for reforming private retirement savings**

As has been discussed here, while the Social Security leg of the retirement stool is eminently fixable, defined-benefit pensions are quickly becoming a thing of the past. The retirement stool metaphor should be abandoned, and the federal government should quickly act to reform our private saving incentive programs – 401(k) and 403(b) programs, and IRAs – to expand and encourage personal retirement savings. The boom in the older population means that Social Security simply cannot be expected to supply more than a bare-bones retirement for every American over 67 beyond the near future. The reform we suggest would encourage saving by making access to 401(k)-style plans universal, expand saving by requiring employers to contribute and match, and protect retirement balances by discouraging and preventing early withdrawals.

#### *Mandating employer participation*

First, every employer should be required to make available to every employee - regardless of their standing as full-time or part-time - a 401(k)-class investment plan, and contribute 2% or more of the employee's income. Further, employers should match another 2% - for a total of 4% from the employer and 2% from the employee - up to a maximum employer contribution of \$1500 per year. The 2% employee-side contribution should be "opt out," meaning the employee must actively choose *not* to participate, instead of "opt in" where an employee would have to actively choose the opposite.

#### *Transcending account portability*

Second, the problem of 401(k) account portability should be transcended. Each employee should take his or her account along to new jobs, instead of having to transfer, or "roll over," money accrued while working for one employer into a new account with a new employer. This will help workers avoid the tendency to liquidate their accounts during the transfer process, and lead to more significant retirement balances in the future. Further, workers with more than one eligible position should be able to have contributions from multiple employers, in addition to their own contributions, all deposited into a single account.

Companies would still be responsible for choosing which depository their employees will utilize initially. However, individual workers ought to have the right to choose a different depository for their investments at least once a year, during an open-enrollment period. This period would be similar to the open-enrollment period for health care providers, allowing individuals to sign up with depositories for minimal fees, and without penalties against their savings. Such an option will increase competition among financial institutions and force them to compete against each other in providing quality services for individuals enrolled in their retirement plans.

We believe the mechanisms for accomplishing the unified account model already exist. Americans are currently allowed to contribute pre-tax income into traditional

Individual Retirement Arrangements (IRAs), and corporations have shown themselves to be proficient at directly depositing money into myriad employee bank accounts, as well as presenting investment options to employees for their classic 401(k) savings. The new challenge of helping employees choose competent, low-fee mutual funds for their savings in what amounts to an expanded IRA should not prove prohibitive.

*Keeping retirement funds where they belong*

While we believe that these reforms alone would dramatically increase the aggregate retirement savings of Americans, more must be done to stem the tide of early withdrawal. Under our plan, neither the mandated employer contribution of 2% of wages, nor the additional matching funds contributed by the employer could be withdrawn before retirement age. Any contributions the employee makes would be available for early withdrawal, but at minimum, current penalties would apply.

As years go by and inflation varies, these new savings mandates must keep up. Like Social Security, a Cost of Living Adjustment (COLA) should be performed annually to keep the maximum employer contribution (starting at \$1500) current.

*Annuities: A sensible choice for retirees*

Finally, too many retirees withdraw their 401(k) funds in a lump sum upon retirement. This subjects retired workers to the same dangers the current 401(k) program does – it puts them in the position of financial planner, a role not every American is prepared for. Instead, the default payment plan – which employees and newly retired people would have to opt out of – should be an annuity geared to last throughout retirement. To discourage opting out, funds remaining in the new retirement account upon death could be exempted from estate taxes (given the floor for the estate tax, this provision would very rarely be triggered) and new penalties could be introduced for lump-sum withdrawal.

*Explanation by example*

Consider a current worker with two part-time jobs. The probability is that neither employer would offer such a worker a 401(k) program. Even if such a program were offered, the employer match is likely to be minimal or non-existent. The result is an insignificant incentive for the worker to contribute to her own retirement account. The worker would be further discouraged from contributing because of the challenges associated with maintaining, combining or transporting any such account upon leaving either job.

Under our system, this worker would be automatically enrolled in a 401(k) style plan to which both employers would contribute, unless she opted out. There would be a strong incentive to contribute at least 2% of wages to the retirement account: Doing so would not only provide the worker with the mandated contribution, but also with the mandated match. Her total compensation would be 106% of her wage. Furthermore, if she stopped working for one employer and became a full-time employee of the other, she would not experience the hassle of rolling one account into the other.

Even if multiple part-time positions were consistent with the worker's long-term employment history, she could expect over her working years to build a considerable 'nest egg' into this new account with little effort beyond just remaining employed. A worker contributing 2% of wages would save 6% of her total compensation through \$37,500, and 2% beyond that.

Once she reached retirement age, she would be encouraged to opt for an annuity, which would be paid to her monthly in a manner similar to her Social Security payments. If this worker consistently earned \$30,000 a year (in 2009 dollars) throughout a 40 year career, she would save the equivalent of \$1800 a year (two thirds from her employer) and, assuming 8% average annual interest, would have the equivalent of \$187,000 at age 67 (about \$900,000 in 2049, assuming 4% average inflation). A more conservative investment strategy yielding a 6% return after retirement, would result in an annuity of more than \$1000 per month that would not expire until she turned 107! When combined with current average Social Security benefits – and the mandated above-poverty benefits we outlined above – this employee would receive well over the equivalent of \$20,000 per year in retirement annuity payments, allowing her to keep a standard of living at or near what it was during her working years.

Even if our example employee regularly withdrew her contributions and only really saved the 4% from her employer, she would retire with almost \$125,000 (in 2009 dollars) and be entitled to an annuity of the equivalent of about \$686 each month. Although her retirement account benefits could not be guaranteed in the same way Social Security benefits are, it is very likely that she would continue to receive consistent payments throughout her natural life.

### *By the numbers*

According to *The CIA World Factbook* (2009), the U.S. workforce (including the unemployed) was about 154.3 million people in 2008. Economists recognize "full employment" at around 5% unemployment, so we assume that in a good year, 95% of the workforce will work – approximately 146.6 million people.

In order to approximate liberally the costs of our private saving proposal (and therefore approach the issue of political feasibility conservatively), we estimate that 60% of individual workers make more than \$37,500. (This is liberal because it is based on Census statistics for men age 18 and above (Bureau of the Census, 2006), and the earnings disparity between men and women in America is well documented.) Among these, 80% will maximize the employer contribution (\$1500) annually and the remainder will realize two thirds of it (\$1000). Among the 40% of the workforce that makes less than \$37,500, we assume that the average employer contribution will be \$750, or half of that allowed. This amounts to an average employer contribution of \$1140 per person.

Using 146.6 million as the engaged workforce, the approximate cost in 2008 would have been \$167.1 billion. Some portion of this new mandate is already being satisfied by employers who voluntarily match their employees' wages, so we estimate new mandated outlays at \$117 billion (30% already being satisfied). Some portion of this new requirement will surely be accounted for by using it as a benefit "floor": an excuse to *lower* employee benefits to the required level. We further estimate the remaining annual liability after this adjustment to be \$81.9 billion (30% of the remainder accounted

for through employer adjustments). This is equal to approximately 22.1% of the federal government's total corporate income tax revenue in 2007, or about 18.8% of payroll taxes paid by employers in the same year (Tax Policy Center, 2009).

### **Now what? Inspiring public action**

#### **Public Involvement in Social Security Reform**

Our proposed Social Security reform solves the program's demographic and fiscal problems in a clear, workable manner, but how can we accomplish this politically? The way that Martha Derthick (1979) categorized the politics surrounding the program in her classic study – as policy made by a narrow group of actors due to lack of conflict – is no longer the case. The level of involvement has increased exponentially since this characterization of the politics of Social Security.

The politics around Social Security reform have been paralyzed in recent years because older adults are justifiably afraid of changes that directly affect their basic livelihood. But it is important for decision makers to recognize that young adults have a stake too, to bring them into the deliberation, and utilize the untapped resources of this well-educated demographic. The linchpin of our proposal is to incorporate all age groups among the public in the decision-making process. This can be accomplished by channeling information through various media – television, internet and viral marketing, and community organizing.

At the same time, policymakers and the public need to develop a common understanding of the problem. This can be achieved through transparent discussion among political leaders who comprehend the basic reforms we propose, and can deliver a cohesive plan to the public. Bipartisan support is necessary for the plan to be taken seriously and to ensure its success. If the public is informed of the urgency of taking action by a united legislature, the reforms are more likely to withstand an onslaught of disparagement from those who wish to stymie change.

#### **Policymaking willpower: A necessary ingredient in private saving reform**

Let there be no illusions: the mandated provision of 401(k)-type plans and requiring employers' contribution to them will not be popular among the business community. Companies are eliminating defined benefit pensions for a reason, and they will not be eager to subsidize an alternative to those plans.

Looking at the big picture, though, companies are largely responsible for the crisis in retirement funding today. The elimination of defined benefit retirement plans has contributed greatly to the financial instability of many elderly Americans. The "three-legged stool" was disassembled by the same employers that had been providing one of the stronger legs. It is not realistic for them to expect their employees to compensate for the elimination of this source of retirement income on their own, and these individuals – in an ideal world – would not be forced into the position in which they find themselves now.

That said, what has been proposed regarding the employer matching and mandated contributions is a modest proposal, one that ought to appeal to companies at

least more than a mandate to provide defined benefit pensions. Just as some health insurance companies and doctors have partially seen the wisdom of health care reform, the American business community should be made aware of the ultimatum that already faces them. Either they will help their employees achieve a secure retirement, or corporate taxes – along with most other kinds of taxes – will inevitably skyrocket as we are unable to meet our entitlement program commitments to a growing contingent of less fortunate citizens. Even more vital than new ideas is new courage on the part of policymakers.

Our proposal could also prove unpopular with the major depositories of 401(k) plans. However, this mandate for universal eligibility and for individual control could actually prove a boon to these depositories. Our proposal represents a major expansion in demand for 401(k) plans. Instead of competing with a smaller market of companies for a block of 401(k) plans, depositories would be competing for individuals' business and loyalty. Not only would increased competition benefit workers, but all the individuals who were off-limits because their employer utilized a particular vendor would be up for grabs.

In the world of the free market, a larger market is preferable for the provider of a product, and more competition is preferable for the consumer. The supply and demand side of this proposal is clear: the demand would be greatly increased, and the individual's choice of depositories ought to alter the market of suppliers of 401(k) programs. Naturally, those benefitting from the *status quo* are loath to change it – upon closer analysis, though, this would greatly benefit the depositories that produce superior products.

The missing link in our plan is less corporate acceptance, and more congressional willpower: companies have, over and over again, adapted to new systems and regulations. The Darwinian model of business survival dictates that they will change in whatever way is necessary to survive. Policymakers must endeavor to give corporations a menu of policy choices *that are beneficial to Americans* – if companies choose from such a list instead of creating and enforcing their own options, then our nation will benefit as a whole.

## **Conclusion**

Retirement policy's impending problems have been set out in stark relief: Social Security faces a large shortfall, corporate pensions are on their last legs, and private saving – even in the presence of incentives like the 401(k) – has declined to intolerable levels.

The obituary to the American retirement is premature though. Social Security can be bolstered by indexing the retirement age to life expectancy, removing the cap on earnings subject to payroll taxes, and devoting the estate tax to addressing the program's legacy costs. The private saving crisis can be addressed by expanding and mandating 401(k) programs, and reforming them in ways that encourage workers to let their investments grow over the long term.

These reforms can be implemented at reasonable costs, but we acknowledge that they will not be enacted without the involvement of our generation and a strong will on the part of our elected representatives. We advocate educational programs to inspire

involvement, and realism on the part of Congress – the central truth that corporations will adapt to changing regulation should not be ignored, and we believe their arguments against our proposals are inevitable and without base. Above all, we choose to dream of a country in which people come before profits, and where policymakers realize they can support the former without extinguishing the latter.

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