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In Brief

US Pension Reform: Lessons from Other Countries

Martin Neil Baily and Jacob Funk Kirkegaard • February 2009 • 384 pp. ISBN 978-0-88132-425-9 • $26.95

With the onslaught of the economic crisis and the United States projected to run historically large budget deficits in the near term, the imperative to reform America's entitlement programs is stronger than ever. Only via combining the large short-term crisis-related outlays with expeditious long-term government budgetary correction can confidence be restored in the US government's fiscal sustainability. As the Barack Obama administration has indicated, reform of US Social Security is both a crucial and feasible part of this process.

The Social Security system, if left unreformed, will run out of money as the baby-boomer generation (Americans born after 1945) retires and lives longer than earlier generations. The number of workers paying contributions into the system is declining relative to the number of those receiving benefits, and as more baby-boomers retire and collect their benefits for a longer period, the current annual surplus of Social Security will turn to deficit over the next decade. The Social Security Trust Fund will finally be exhausted around 2040.

In addition to the fiscal challenge, the overall US pension system faces several other problems: providing adequately for retirement income and old age poverty; supporting labor market participation and economic incentives for older workers; preserving soundness of state and local government, as well as corporate, pension plans; contributing to the low US national saving rate; and affecting income redistribution between generations.

These challenges are not unique to America but are shared throughout the industrialized world. Policymakers in all advanced countries have had to wrestle with the same set of pension policy–related issues and, in fact, many face more rapidly aging populations and harsher long-term economic circumstances than the United States. Pay-as-you-go plans—which is what Social Security is—are facing large deficits in many other countries, and these fiscal shortfalls share a common explanation. Most developed countries experienced strong economic growth in the 1950s and 1960s, which resulted in large inflows of revenues from the payroll taxes that funded the retirement programs. In addition, the cohort of retirees was small and most workers continued to work into their mid-to-late 60s. Hence politicians could be generous to retirees without fear of program deficits in the short run. But economic growth has slowed since then, the number of workers has stagnated and populations are living longer.

In this study, Baily and Kirkegaard explore how other advanced countries such as the United Kingdom, France, Germany, and Japan, as well as a host of smaller countries have addressed the same fundamental problems facing the US pension system. Their assessment reveals that the design of US Social Security is fundamentally sound and that it compares favorably with the systems in other advanced economies. Two of its virtues are its modest scale (thus it does not displace a lot of private saving for retirement) and its adjustment of benefits based on age of retirement (thus it does not encourage early retirement very much).

The authors highlight the fiscal imbalance, lack of adequate household saving, and lack of redistribution from high- to low-income participants as the key problems that need to be addressed in the US pension system. They conclude that no single policy tool is sufficient to "fix" any pension system. The inherent complexity of such systems and the required broad political backing for any reform to work in the long run require the simultaneous use of different policy tools to "distribute the reform pain" across both pension contributors (taxpayers) and beneficiaries (current retirees). The goal is to find a way to put the Social Security retirement program on a sustainable path in a manner acceptable to the broadest possible coalition of constituents.

Drawing inspiration from the pension reform experiences of other rich nations, Baily and Kirkegaard present a set of interconnected reform proposals. To deal with the fiscal shortfall, they propose:

1. *Targeted benefit adjustments that better integrate Social Security with private, tax-advantaged pension plans:* Americans in the top income quintile derive most of the economic subsidy bestowed by government to private, tax-benefited retirement plans, whereas the overwhelming majority relies almost exclusively on Social Security: More than a third of Americans have no retirement savings at all, and of those who do, more than a third have less than $10,000. The federal government spends about $120 billion (and rising) annually in tax expenditures to promote retirement saving, which goes disproportionally to high-income Americans. The authors propose to cut future Social Security benefits through some proportional formula for this group of high-income Americans (likely earning over $100,000 a year) who take advantage of government provided tax breaks for their private retirement saving.

   Given the $120 billion in annual tax expenditures toward retirement saving and at least $80 billion in Social Security benefits to recipients in the top income quintile, the authors believe a reduction in annual benefits of about $30 billion to $40 billion is possible by targeting those who take advantage of tax-preferred pensions. Thus their pension integration proposal would save upto 50 percent of the Social Security benefits paid to recipients in the top income quintile.

   Pension integration addresses only part of the benefit reduction that would be needed, along with some revenue enhancements, to generate fiscal balance for the program into the future. The second part is to adjust the age of retirement.

2. *Continued adjustments of the normal retirement age after 2027:* The age of retirement has a huge impact on the retirement pension budget. While expected lifespan has increased in all advanced countries, the age of retirement has declined since around 1970, and the combination of these two effects has sharply increased the number of years spent in retirement and put tremendous strain on pension budgets. The authors propose to link the eligibility ages for early (currently 62) and full (rising gradually to 67 by 2027) Social Security benefits to changes in life expectancies after 2027 in a way that keeps constant the ratio between expected years spent in retirement and the rest of an individual's lifetime. This would mean that the earliest age (now 62) of reduced Social Security benefit eligibility would also rise with life expectancy.

To respond to the low saving rate in the United States, Baily and Kirkegaard propose:

3. *A system of add-on individual accounts:* The idea of replacing the existing Social Security retirement program with individual accounts did not find support in Congress or with voters. Nevertheless, the concept of low- and middle-income workers having additional individual retirement savings, over and above their Social Security benefits, is a good one. Moreover, the government can play a legitimate role in making it easier and cheaper for lower-income families to save. Under the plan, workers would be automatically enrolled in a 401(k)-style individual account managed by the Social Security Administration but with the funds invested privately. Participants could opt out of the program without penalty. The plan would add not only to the retirement resources of future generations of elderly but also marginally to national saving.

US policymakers who push Social Security reform into the future impose an unnecessarily large and intergenerationally unfair burden on future generations. Social Security reform is a political challenge but, in the words of Abraham Lincoln, "You cannot escape the responsibility of tomorrow by evading it today."

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