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Social Security, the Financial Crisis, and Lessons from Abroad

*Jacob Funk Kirkegaard, coauthor of US Pension Reform: Lessons from Other Countries, assesses the vulnerabilities of the US social security and pension systems and how other countries are tackling the same problems.*


Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman at the Peterson Institute for International Economics. Our guest today is Jacob Kirkegaard, research fellow at the Peterson Institute and also the coauthor of a book entitled, US Pension Reform: Lessons from Other Countries.

You and your coauthor, Martin Baily of the Brookings Institution, have written a timely book about the state of US pensions. What has been the impact of the crisis on the state of pensions in the United States?

Jacob Funk Kirkegaard: Thank you, Steve. First of all, the financial crisis has not had any immediate and direct impact on Social Security. The only, you could say, indirect and long-term impact that the financial crisis has had on Social Security is that it has obviously worsened the broader, long-term fiscal challenges of the United States. So that is an issue. But where the financial crisis has had a very large and very immediate impact is on people’s personal IRAs, 401(k) pensions, the pensions of state and local governments, as well as corporate pensions. It’s not unheard of that people have suffered losses in the 40 or 50 percent range.

Steve Weisman: Could some of these problems eventually become a claim on the federal budget?

Jacob Funk Kirkegaard: I think you’re highlighting a very important issue here because the whole idea of Social Security as it was conceived by President Roosevelt in the 1930s was essentially to alleviate old-age poverty. It was basically to prevent what until then had been a general state of affairs that old people were poor people. And if you are now in a situation where people had been expecting to live fairly well out of their state or local government pension or corporate pension or their own personal IRA, which has now been decimated to the tune of, say, 50 percent, they’re going to be very unhappy about that obviously. As we say in our book, there is a significant risk that a number of state and local government pension funds will go bust. In that case, I think it’s very likely that some of these retired state and local government employees are going to turn to the federal government and say, “you bail us out like you bailed out the Wall Street bankers.”
Steve Weisman: How much does the United States rely on the government to provide pension relief for old folks compared to countries in Europe? Do they do it through private savings or through the government?

Jacob Funk Kirkegaard: It depends on how you look at it. If you look at the number, the dollar figure, in terms of the number of assets that are privately saved in the United States, one of the quite surprising things we found in our book is that there is actually an awful lot of private retirement savings in the United States.

Steve Weisman: But it’s not evenly distributed among Americans.

Jacob Funk Kirkegaard: No, that is exactly the key problem. This is data from before the crisis, but there the data show that there was upwards of maybe 130 percent of GDP in earmarked savings for retirement, which compared to countries in Europe is among the highest—not just in Europe, but in the entire OECD.

Steve Weisman: You often hear the claim that Americans’ savings rate is very low.

Jacob Funk Kirkegaard: Yes, exactly.

Steve Weisman: What you seem to be saying is that it’s high but it’s not shared by everybody.

Jacob Funk Kirkegaard: Exactly. When you look at savings and who benefits from the capital earnings of all this capital, then you will see that the bottom four income quintiles of Americans rely overwhelmingly on Social Security for their retirement income. It is only once you move into the top income quintile that Social Security does not in fact constitute the majority of your income once you retire. And in that sense, the United States is not that different from the rest of the world. It is a general characteristic of OECD countries that governments directly provide retirement income for everybody except the top earners.

Steve Weisman: The OECD is the organization of the leading industrial democracies in the world. The United States is the only member of the OECD in which income inequality among the elderly is higher than it is in the rest of the working population.

Jacob Funk Kirkegaard: That was another one of the discoveries that we found as we started comparing different countries. Everyone knows that income inequality in the United States as a whole is much higher than it is in Europe, or actually I should say in most European countries, because of income redistribution through the tax system. But we were very, very surprised to discover that in the United States, retirement savings are concentrated among the richest Americans. But there’s another reason as well, which is that here we’re talking about the total income in old age, meaning people over the age of 65. Another important difference is that a number of people continue to work after the age of 65, and that group is overwhelmingly those who are already
making a lot of money, the well-off. So they continue to work and earn a living even though they are above the retirement age, so to speak, which is another thing that exacerbates the income inequality.

Steve Weisman: Now, the current crisis is probably going to compel many, if not most, workers to work past their traditional retirement date of 65. Is that what you expect in the United States, and will that trend also show up in other leading advanced countries?

Jacob Funk Kirkegaard: Yes, I think that is what we already have been seeing. You started to see some of that in the United States already after the downturn in 2001. And this is something that you have also seen in other countries, although in other countries, this has partly also been because of pension reforms such that governments have made it very difficult or much more difficult for people to retire at an earlier age.

Steve Weisman: Is there an obligatory retirement age in Europe, let’s say vis-à-vis the United States? In Social Security, there’s a financial incentive for postponing your retirement. Does that also exist in other countries?

Jacob Funk Kirkegaard: That’s actually one of the reasons why we consider Social Security to be a fundamentally very sound, fair, and sensible system—precisely for some of the reasons that you just mentioned. In Social Security, you do have the early retirement option at 62, but that means that you will be taking a significant cut in your monthly benefits so you have a strong financial incentive to continue to work at least until 65. And that actually sets Social Security apart from many, particularly European, countries, where there is no financial disincentive for retiring early. In many countries—most notably in countries such as Germany and France—you could retire in your late 50s with a full, government-paid pension.

Steve Weisman: Has that changed?

Jacob Funk Kirkegaard: That has gradually changed.

Steve Weisman: And probably will continue to change?

Jacob Funk Kirkegaard: Oh, absolutely, because you could say that unlike the case of the United States, where clearly health care is the number one long-term fiscal challenge for the federal government, in France and Germany it was actually pension systems. And it was the unsustainable pension systems that posed the biggest long-term fiscal threat. So these countries have had to be very proactive in reforming them.

Steve Weisman: What lessons can the United States learn, if any, from the European experience on reforming their pension, both public and private, systems?
Jacob Funk Kirkegaard: I think there are several key issues. One of the things that we found was a very clear trend that when you're reforming a pension system that affects the majority of a country's population—such as obviously Social Security—you almost invariably have to do it through a combination of several different measures. You cannot, for instance in the case of Social Security, solve it by just raising the payroll tax or just cutting benefits. You almost always have to do it by a combination of raising taxes perhaps a little bit for some people and cutting benefits a little bit for other people.

Steve Weisman: And raising the retirement age.

Jacob Funk Kirkegaard: Yes, that was the thing I was going to come to, which is that other countries’ experiences clearly show that one of the most effective ways of solving or rendering a pension system sustainable in the long term is raising the retirement age. One of the things that we also found was that if you compare the effective retirement age—which means the average age at which people actually stop working, not the statutory or mandatory retirement age, which in Social Security is between 65 and 67, but the age at which people actually stop working—if you compare different generations, it was quite staggering what we found. In 1970, the average effective retirement or age, or withdrawal as some call it, in America was between 67 and 68 years of age. Don't forget, that was at a time when the average life expectancy was much lower than it is today. So effectively what you had was that people spent a much smaller share of their total lifetime in retirement. What we've basically seen in the United States, but much more prevalently in Europe, is that you have had this unfortunate situation since the 1960s and early 1970s of rising life expectancies but declining average ages of retirement. So the time spent in retirement has been going up very, very rapidly. And that's one of the reasons why raising the retirement age or linking the retirement age to life expectancy, as we propose in the book, has proven to be such a powerful tool.

Steve Weisman: Well, we'd all like to retire early and live longer. But it sounds like that is not a recipe for the long-term solvency of our pension system as a whole. Thank you for sharing with us some of your proposals on this. Good luck on the book, which again is titled US Pension Reform: Lessons from Other Countries. It'll be published in February by the Peterson Institute for International Economics.

Thanks again, Jacob.

Jacob Funk Kirkegaard: Thank you, Steve.