1

Lessons from the World

We know exactly what to do, but we do not know how to win the next elections after we have done it.

—Jean-Claude Juncker, prime minister of Luxembourg[1]

When a new presidential administration takes office in January 2009, an important item on the policy agenda will be Social Security reform. The large cohort of Americans born after 1945 is starting to collect Social Security benefits, and over the next several years the surpluses of Social Security tax receipts over benefit payments will become deficits. Social Security is a pay-as-you-go (PAYGO) system, and the number of workers paying contributions into the system is declining relative to the number of those receiving benefits. Increases in life expectancy, although for the most part a positive development, also contribute to the financial concern.

In addition to the fiscal challenge, Social Security faces the challenge of adequacy. A large fraction of retirees relies on Social Security benefits for most of their income. For the average worker, the level of benefits is not very high—$990 for all beneficiaries in April 2008 ($1,083 for all workers and $533 for spouses).[2] Elderly poverty, particularly among widows, is a significant problem. Furthermore, even if retirement benefits were adequate today, they would not be in the future because of the rising costs of health care. Medicare covers retirees without alternative coverage,

1. BBC News, "Campaign To Cure EU Labour Woes," March 23, 2006.

2. Data are from the Social Security Administration, www.ssa.gov.

Peterson Institute for International Economics | www.petersoninstitute.org

and its costs are rising enormously; most observers conclude that the cost of Medicare is unsustainable (see, for example, CBO 2008). Ideally, reforms will preserve effective care while reducing costs, but it is likely that retirees will nonetheless have to pay more for their health care. However, at the average level of pension benefits, it is hard to see how retirees dependent on Social Security income will be able to pay more for health care. Thus the dual challenge for the US Social Security system is to improve its solvency while maintaining an adequate standard of living for retirees who have come to depend on its benefits.

The United States is not alone in the fiscal challenges to its public retirement program; PAYGO plans 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, so politicians could be generous to retirees without fear of program deficits in the short run. But economic growth has slowed since then, and populations are living longer. The number of retirees has increased rapidly as the retirement age has fallen in most countries, the baby boomer generation is moving into retirement years, and life expectancy is increasing. Furthermore, the number of active workers is actually starting to decline in some countries, so that the ratio of workers paying into the system has declined relative to the number of retirees receiving benefits. This trend is expected to continue, although the effective retirement age has begun to stabilize in most Organization for Economic Cooperation and Development (OECD) economies.

Many of the countries that we analyze in this study, especially the European economies, pay more generous public pensions than does the United States. The dilemma for policymakers in these countries is that any reform efforts that call for reducing benefits or increasing taxes are very unpopular politically. In Europe there have been demonstrations and even riots triggered by proposals to cut benefits or increase the age of retirement. Tax increases are not as unpopular in Europe as in the United States, but European policymakers are very aware of their already high levels of taxation and the possible incentive problems these may create, especially in a global economy where high-income, high-tax individuals have the option of moving to a country with lower tax rates.

The goal of the study that constitutes this book, commissioned by the Ford Foundation, was to identify lessons from the experiences of other countries that may be useful to the United States in reforming its Social Security program. When the study agenda was first formulated, establishing individual accounts as part of the public retirement program was at the forefront of the US policy debate, and the Ford Foundation asked us to look at the track record of such accounts in other countries.

Peterson Institute for International Economics | www.petersoninstitute.org

The George W. Bush administration had made proposals that, if fully implemented, would have drastically changed the nature of the Social Security program. The Bush administration had suggested individual accounts, which would enable workers to divert a fraction of their Social Security tax contributions to a retirement fund with a portfolio of financial assets that would generate retirement income. In return these workers would receive a smaller benefit from the traditional Social Security program. But the individual accounts were not aimed at reducing the system's funding deficit; rather, the shortfall in Social Security funding would be addressed by varying the amount of indexing in the benefit formula depending on the level of recipients' income. Social Security benefits would gradually become a smaller portion of retirement support for middle-class Americans, who would instead be encouraged and expected to invest in individual accounts together with private retirement accounts, whereas low-income workers would continue to receive the same level of benefits as under the current system. Social Security would thus become an antipoverty program for the elderly, not the broad retirement program it is today.

Whatever its merits and flaws, the Bush plan for individual accounts is generally considered dead, as it achieved no political or popular acceptance. Because the lessons from foreign experiences of individual accounts may therefore seem less relevant, we broadened the scope of this study to consider a much wider set of pension policy issues in many countries, including statutory and actual retirement ages, distributional challenges, and the intersection between public and private retirement plans.

Importantly, however, despite the change in the United States policy debate, we retained an emphasis on individual accounts because we believe that the creation of such a program, as an addition to the current Social Security retirement plan, is important, perhaps even essential, for the future of older Americans of moderate income. The Bush administration's mistake was in trying to replace the current Social Security retirement program with such accounts. The existing Social Security program is broadly popular, and although it faces a significant fiscal challenge, this challenge could be overcome by modest adjustments on the revenue and benefit sides.

In fact, one of the key lessons from this international comparison is that the current US Social Security retirement program has substantial virtues. The fact that the benefit levels are modest carries the advantage that the program does not cause significant changes in private behavior, such as early retirement or the displacement of private saving for retirement. The small impact on employment decisions is reinforced by the adjustment of benefit levels depending on the age at which people first take benefits. The modest benefit levels also mean that the program's funding shortfall is not particularly sizable, in comparison with many countries where more generous public pension benefit levels have effectively displaced

Peterson Institute for International Economics | www.petersoninstitute.org

most private pension programs (which are much higher in the United States than in other countries). With a few exceptions, these countries have not accumulated trust funds for their public pension programs and must pay for future benefits from future payroll taxes, so their funding shortfalls are much larger.[3]

After reviewing public pensions in many countries, we concluded that the first problem to address in US retirement policy is that low-wage workers do not save and rely too heavily on Social Security benefits. A virtue of the US Social Security system—its modest scale—also means that workers who do not save end up with inadequate financial resources when they retire.[4] Any broad increase in the generosity of benefits is not going to happen in the United States, because it would exacerbate the system's funding problems. That means another solution is needed to the problem of inadequate income for the elderly: namely, a plan to increase saving among low- and moderate-income households. We believe that a program of individual accounts to supplement Social Security benefits would be a valuable contribution.

After comparing individual account programs around the world, we found that the Bush administration proposal for such accounts was well designed. It was based on the work of an expert commission[5] convened in 2001 to design a program of individual accounts that would avoid most of the problems of such plans in other countries. This design should form the template for a program that automatically enrolls US workers in supplementary individual retirement accounts.

The Social Security Administration would administer the program and the Internal Revenue Service (IRS) would collect the money, which would range from 2 to 5 percent of Social Security wages. These government agencies would be precluded from either investing or controlling how the funds are invested and how any equities holdings are voted; private managers, under the supervision of an independent board of trustees, would handle the investment of funds. Workers would be able to opt out of the program, but there would be incentives for them to participate. The administrative costs of the plan, except for a fee paid to the fund managers, would be covered by general tax revenues. Employers who did not offer a private retirement plan to their employees would be required to

3. As Peter Diamond reminded us in comments on this chapter, whether or not there is a trust fund does not indicate the underlying cost of supporting future retirees. With lower per capita income and labor force participation, however, the fiscal challenge facing many European economies is substantial. The US economy has the additional concerns of a much higher cost of health care and a large net foreign debt.

4. McKinsey Global Institute (2008) describes the lack of preparedness for retirement among the baby-boomer generation.

5. The President's Commission to Strengthen Social Security released its report on December 21, 2001. It is available at www.csss.gov/reports.

Peterson Institute for International Economics | www.petersoninstitute.org

match the employee contributions.[6] In addition, the minimum age at which workers could start collecting Social Security benefits would be higher for workers that failed to participate in the retirement program, unless they had an adequate private retirement plan. This provision would prevent low-wage workers who retire at age 62 from becoming poor at later stages in life at age 85 or 90. Participants would be automatically enrolled in an age-adjusted default portfolio of bonds and stocks but could opt out after signing a waiver. Many higher-income employees enrolled in employer-sponsored retirement plans would likely opt out.

The second problem with the US Social Security program is its funding shortfall. As we have noted, the funding problems of the Social Security retirement fund are small relative to those in many other countries; however, they still need to be addressed. We also support a continued increase in the retirement age over time as life expectancy increases. The funding shortfall is a solvable problem.[7] However, our international study gave us a particular perspective on the issue. We were struck by the uniqueness of the United States in its reliance on tax preferences to support social insurance. Health insurance for those under 65 can be purchased with before-tax dollars. Home ownership (arguably a form of social insurance) can be financed with tax-deductible mortgage interest payments. And, of course, individuals can save for retirement out of before-tax dollars and employers can offer tax-preferred retirement benefit plans All of these provisions are advantageous primarily to upper-income households, and all are very popular politically and unlikely to be changed any time soon (in fact, the scope of retirement saving out of after-tax dollars has been significantly expanded in the last few years).

Another weakness of the US Social Security retirement plan is that it does not redistribute from high- to low-income participants.[8] The average retiree receives $1,000 to $1,500 a month, as we said earlier, but a married person who is a household's single wage earner and retires at 65 at the maximum level of Social Security benefits would receive over $3,000 a month. The lack of redistribution is not uncommon around the world, but some countries have retirement payments that are substantially more redistributive.

---

6. It is common for employers to have a vesting period for their retirement plans, such that short-term employees are not credited with anything in their retirement accounts when they leave. Such employers (including small businesses) would have to at least match their employees' contributions to the national plan.

7. There are several good proposals already on the table, notably the plan presented by Peter Diamond and Peter Orszag (2005).

8. Social Security overall is redistributive because of the disability and survivor benefits that disproportionately benefit lower-income recipients. On the other hand, the retirement program's spousal benefits favor husband-and-wife households with only one earner, and these are often the more affluent households.

Peterson Institute for International Economics | www.petersoninstitute.org

Overall, therefore, the US Social Security retirement program and tax code provisions for private pensions provide significantly larger financial advantages to upper-income than to lower-income households. Retirement income has been likened to a three-legged stool, with public pensions, employer pensions, and individual saving as the three legs. Because two of these favor high-income households, we conclude that reducing the level of Social Security retirement benefits for higher-income workers is justifiable as part of an overall plan to address the funding shortfall. The approach is based on the principle of fairness: Those who benefit most from tax preferences as they build private retirement wealth receive somewhat less from the public retirement pension plan. We propose linking the size of that reduction to the amount of recipients' tax-advantaged saving during their working life. There is widespread support for both "fixing Social Security" and ensuring that Social Security benefit cuts affect only those who earn higher incomes.[9] We believe that the proposals presented in this book offer an intuitively fair and thus politically sound way to accomplish these goals.

Structure of the Book

The most common approach to comparative cross-country studies of pension systems is to assess each country's experiences and use them to draw broader conclusions. Typically, a native specialist author writes about his or her country, or a country specialist at an international institution like the OECD or the World Bank provides coverage. There are numerous recent studies and reports of this type.[10]

We have chosen to structure our comparative report differently, looking at specific challenges that affect pension systems in aging societies and that present obstacles to pension reform. We have made this choice for several reasons. First, we acknowledge that we could not provide the same level of country expertise available in many country-specific studies. Second, we feel that there is a risk of getting caught up in the details with country studies. Each country's pension system is complex and unique, with a particular history and political anchoring that offer abundant idiosyncratic details and data—so much so that there is a risk that the comparative value of such "pension system anthropologies" is drowned

9. The differential indexing proposal included in the Bush proposals for Social Security reform would have cut benefits for high-income families relative to the current system.

10. See, for instance, Gruber and Wise (1999), Holtzman et al. (2005), Penner (2007), Whitehouse (2007), and many others. The Gruber and Wise study is decentralized, in the sense that national experts made the calculations with an international set of terms of reference. The OECD and World Bank studies were centralized and then checked with national experts.

Peterson Institute for International Economics | www.petersoninstitute.org

in historical minutiae and country-specific data. By focusing instead on challenges that affect all developed economies, we hope to avoid falling into this trap.

Third, we wish to take advantage of recent improvements in the collection and quality of pension-relevant cross-country data, particularly by the OECD. We use such data extensively throughout this report and believe that they provide a sound empirical basis for our cross-country analysis. We do, however, acknowledge that our cross-country data focus limits our analytical options—such that, for instance, we do engage in forward projections for individual countries—and data limitations has been a recurring issue in writing this book.

Fourth, we believe that by focusing on several challenges to the pension system, we avoid "silo'ing" our study: Too often, cross-country studies of pension systems focus on just one aspect (tier) of the total pension system, such as Social Security in the United States and government-run PAYGO schemes in other countries. In this study we extensively cover the challenges facing other parts of the pension system in the United States and elsewhere, most importantly the labor market and corporate pension schemes. Nicholas Barr and Peter Diamond (2008a, 2008b) also identify a comprehensive view of pension reform as a key reform principle. We look carefully at the sizable corporate pensions in America, as these, together with other non–Social Security sources of income, provide the largest share of retirement income for the top income quintile. We believe our broader focus enables us to draw a series of powerful conclusions and offer a reform proposal for the United States that integrates Social Security with other parts of the US retirement income security system.

Fifth, we acknowledge that our focus on challenges in some respects limits our pool of potential countries of interest to relatively "like units" at least somewhat similar to the United States in overall levels of economic development.[11] As a result, with few exceptions (notably Chile and Mexico), we do not venture beyond high-income OECD or EU member countries. However, this scope of analysis enables us to capture most of the international pension reform experiences and challenges relevant to US Social Security.

Last, we also acknowledge that our comparative cross-country methodology has inherent limitations. It is not possible to determine the details of a plan for US Social Security reform simply by looking at what has and has not worked in other countries. We are, therefore, reluctant to identify specific numeric target values for Social Security reform. We do not, for instance, believe that the experiences of other countries are helpful in determining specific revenue-raising measures for US policymakers in their efforts to reform Social Security. Rather, we believe the experiences of other countries are useful and informative in determining the broader

11. See Sartori (1996) on the selection of units for comparison.

Peterson Institute for International Economics | www.petersoninstitute.org

policy areas and tools that have achieved results and thus would be suitable for inclusion in US Social Security reforms, given the particular circumstances found in the United States. Our aim is to provide US policymakers with advice about general directions for reforming Social Security, not to deliver a finely detailed and fully estimated reform proposal.

We begin in this chapter by highlighting the most important findings likely to be of interest to US policymakers, and we then discuss the policy implications of these findings. The following chapters cover most of the OECD economies and assess pensions on many dimensions. Chapter 2 deciphers the fiscal or budget challenge facing retirement programs and how it is affected by demographic change. Chapter 3 discusses the distributional challenge of retirement plans, in terms of both alleviation of elderly poverty and equity among generations and demographic groups. We include a section on the differences between public and private pensions. Then chapter 4 examines the labor markets and work incentive challenges and assesses the extent to which retirement programs alter economic incentives and resulting labor market participation. Chapter 5 looks at individual accounts in practice, with a focus on funded accounts and how the introduction of individual accounts has or has not responded to the challenges. Chapter 6 does the same for notional (nonfinancial) or unfunded individual accounts. Chapter 7 considers the relevance of private employer–sponsored retirement programs to reforms for Social Security and other public-sector programs. Chapter 8 presents our conclusions and integrated reform proposal for US Social Security.

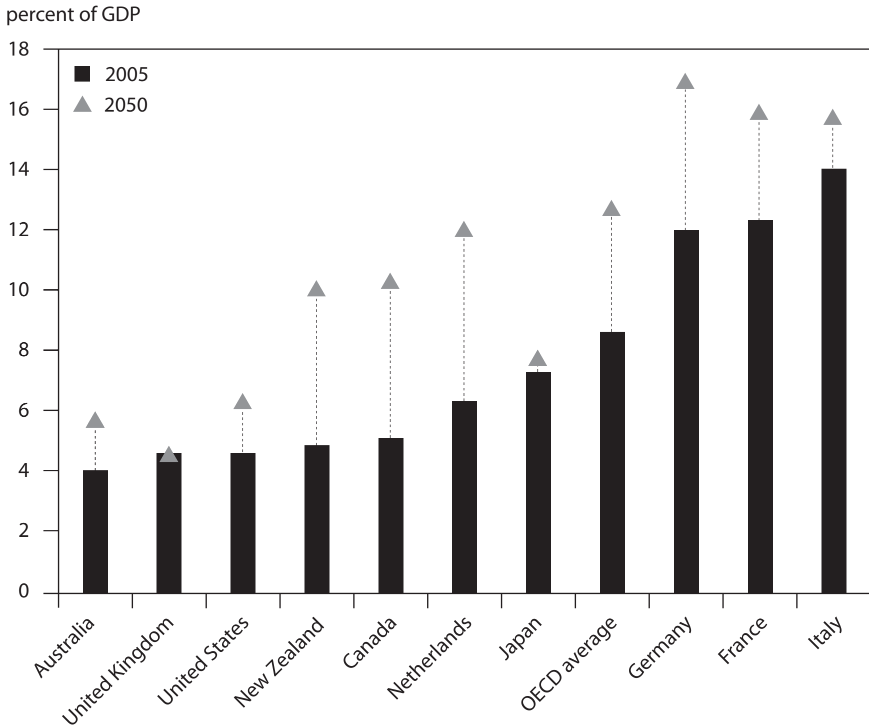
Key Findings

On Fiscal and Demographic Challenges

The fiscal challenges facing the US Social Security retirement program are smaller than in most other OECD countries. The reasons for this finding are as follows. First, the generosity of Social Security benefits is lower than that of most European economies, and so the fiscal burden of future benefit payments is not nearly as large as for those economies. Japan and the United Kingdom are similar to the United States in providing only modest mandatory government pension benefits. Second, the age of withdrawal from the labor market is higher in the United States than in most other advanced economies (Japan is the main exception). In many European countries there is an "official" age of eligibility for a full public pension of around 65, but in practice many workers retire and begin receiving early retirement benefits before then. Third, until the early 1970s, the European economies had labor force participation rates and hours of work comparable to those in the United States; since then, however, unemployment has risen, labor force participation has fallen, and

Peterson Institute for International Economics | www.petersoninstitute.org

Figure 1.1 Gross public pension expenditure, 2005 and 2050



OECD = Organization for Economic Cooperation and Development

Source: Queisser and Whitehouse (2005).

hours of work per employee have declined substantially. Thus the amount of work done by the working age population in Europe is now much lower than in the United States. Fourth, birth rates have declined sharply in some European and North Asian countries, which means that the rate of population growth is low and in some countries there is even population decline; projected population declines in Northeast Asia and Eastern and Mediterranean Europe are very large. Taken together, these trends indicate that the retiree population is being supported by taxes paid on relatively few hours of work and that the challenge of public pension provision is going to get much worse in many countries. Figure 1.1 shows the percentage of GDP going to gross public pensions in 2005 (bars) and 2050 (arrowheads). The United States starts low and increases less than many countries.

We conclude that unlike in many other countries, where the problems in the public pension system are the principal driver of future fiscal trajectories and forces politicians' hands, this is not the case in the United States.

Peterson Institute for International Economics | www.petersoninstitute.org

The US Social Security program is in much better shape than the retirement programs of most other advanced countries. But this does not mean there is no fiscal problem in America. For one thing, US government health care spending is growing rapidly and will continue to do so unless there are major reforms in Medicare. The federal budget overall will therefore be under great stress even though the Social Security fiscal problem is not that serious in international comparison. This is of additional concern because of the persistent substantial federal budget deficit (even recently, when the economy was basically at full employment). In short, the US Social Security program must restore its own solvency because there are a lot of other claims on general tax revenues, making the option of covering the Social Security shortfall with these revenues not viable.

The level of total prefunded assets toward pension provision is very high in the United States. Evaluations of countries' preparations for aging populations usually focus on the state of public finances, but this is only part of the picture, as substantial assets in many countries have been accumulated in the private sector. Surprising, perhaps, to some for such a "low savings economy," the level of prefunded assets for pension provision in the United States is among the highest in the OECD, at 136 percent of GDP in 2006. This substantially improves the comparative level of preparation for aging societies in the United States and emphasizes the scale of the challenges facing some OECD countries (particularly in Southern Europe).

Tax treatment of pension benefits differs widely across the OECD; US taxation of pension benefits is among the lowest. Total taxation levels (i.e., including both direct and indirect taxes) on pension benefits vary from 10 percent or less in Japan, Mexico, and the United States to 50 percent or more in the Scandinavian countries. This difference has a large, but frequently overlooked, impact on the sustainability of public pension systems in the OECD.

The value of tax breaks given to pensions is very high in the United States and a few other OECD countries. When computing the true net level of public pension expenditures, it is not sufficient to account only for the net effects of taxation of benefits; one must further account for the value of tax breaks for pension savings. In the United States these are very high, at more than 1 percent of GDP. This means that the net level of public pension expenditures in the United States is higher relative to many other countries—including Canada, the United Kingdom, and the Scandinavian countries—than many believe.

The adverse demographic outlook is concentrated in Eastern and Southern Europe and Northeast Asia; the United States has the most favorable outlook in the OECD. The United States will continue to experi-

Peterson Institute for International Economics | www.petersoninstitute.org

ence a growing workforce (albeit at a much slower rate) in the first part of the 21st century. The US population will, therefore, merely grow older, whereas most countries in Northern Europe will experience stagnant or mildly declining growth in their working age populations, and their populations overall will age much faster than in the United States. In Southern and Eastern Europe, Germany, and Northeast Asia, the working age population, on the other hand, will shrink dramatically and their populations will not merely age but shrink in the decades ahead.

Immigration is not the answer to the funding shortfall. The fiscal problems of advanced-country pensions are partly the result of declines in population growth. Although it may appear that adding more people of working age could provide an important part of the solution, we found that this was not the reality. Under any realistic scenario of immigration, the fiscal problems will still be severe.

In many countries effective retirement ages matter more than demographics for labor supply. The effective retirement age[12] in the United States at about 63 years of age is only slightly below the age of full pension eligibility (65–67 years for Social Security). In other OECD countries, the difference between statutory and effective retirement ages may be as much as 6 to 7 years, leading to very low effective retirement ages (e.g., less than 60 in France). In contrast, the effective retirement age in Japan is close to 70, indicating a far more robust position than the country's demographic outlook alone would predict.

On the Distributive Challenge

Most developed-country pension programs derive from two historical models. Government retirement pension programs can be traced back to policies developed in Germany and the United Kingdom in the 19th and early 20th centuries. In Germany, Bismarck introduced welfare reforms in 1891, including a contributory pension plan in which workers would pay into the program during their working lives and draw out from it during retirement. And in 1908 the United Kingdom introduced a flat rate elderly pension, paid for out of general tax revenue and means-tested so that only those with low incomes received the pension. It was designed as an antipoverty plan for the elderly.

In the United States, federal financial support for the elderly was not introduced until the Social Security Act of 1935. The first of the act's two parts provided for grants to states for assistance to the elderly who had

12. Throughout this book, we use the standard OECD definition of "effective retirement age": the average age at which persons 40 and older leave the labor force.

Peterson Institute for International Economics | www.petersoninstitute.org

very low incomes. This program, similar in basic structure to the UK plan, was financed by general tax revenue, as it still is, having evolved into the Supplemental Security Income (SSI) program. The second part of the act called for the financing of federal old age benefits by employer and employee taxes; its design is close to the German model.

Until the postwar period the SSI program was far larger than the contributory Social Security plan, for the obvious reason that few retirees had contributed much. There was also no indexing of benefits until 1951, so that real benefit levels were seriously eroded by postwar inflation. Gradually, Social Security became the predominant vehicle for income support of the elderly and SSI is now small in comparison. In other words, in its early decades, the US Social Security system was far more redistributive than it is today.

The historical review helps to put government retirement programs around the world in context. The English-speaking countries often have plans that were designed initially to alleviate elderly poverty rather than as contributory programs. Some are means-tested, as with the minimum benefit in Australia, and some simply provide a low level of benefit to everyone, as in New Zealand. The programs of continental Europe, built more closely on the German model, provide more generous average retirement benefits, scaled to replace a significant proportion of each worker's income at the level achieved in the years before retirement. In practice, most countries have hybrid programs that balance the principle of giving more to those who have contributed more against the principle of redistribution and poverty alleviation. However, the originating principles are still evident; the most generous countries, measured by average benefit levels, are often the least redistributive because they are based on contribution levels.

US Social Security is less redistributive than the retirement benefits of other English-speaking countries. US Social Security is significantly less redistributive than mandatory pension systems in other English-speaking countries with which the United States is normally compared. However, there is no indication in other English-speaking countries (or elsewhere) that higher levels of redistribution in the mandatory pension systems undermines public support for it.

OECD poverty rates for the elderly differ substantially and are very high in some countries. The OECD has its own definition of poverty, based on *relative* income—persons receiving less than 50 percent of median income (after adjusting for household size). In the United States in 2000, this meant a poverty-level income of about $12,000 rather than $8,300, which was the official US poverty level for a single adult. Based on the OECD definition, the US old-age poverty rate is above average for the OECD membership, although this is in part because of the high median

Peterson Institute for International Economics | www.petersoninstitute.org

income of nonelderly US households. However, also according to the OECD definition, over 30 percent of persons over age 76 in the United States live in poverty.

In nearly all OECD countries, including the United States, most of the income of elderly families comes from government pensions (except for the highest income groups). The key similarity between the United States and other OECD countries is that retirees outside the top income quintile rely entirely or predominantly on Social Security and public payments for their income. Only among retirees in the top income quintile (except in Japan) does income from private capital or employment beyond retirement age constitute a substantial part of retirement income.

Time spent in retirement has substantially increased in recent decades. With the combination of rising life expectancies and declining effective retirement ages, retiring generations in the OECD can look forward to 5 to 10 years more in retirement than their parents' generation.

Directly linking life expectancies to retirement ages is increasingly popular in mandatory pension programs. Many countries have introduced prefixed increases in the eligibility ages for (both early retirement and) full pensions, as the United States did for Social Security in 1983. An increasing number of OECD countries are also linking eligibility ages in mandatory pension systems directly to changes in life expectancies, sometimes in addition to (i.e., coming into effect after) prefixed rises.

Life expectancy varies by income and education. Data from the OECD countries reveal a relationship between income level and life expectancy that contributes to a distributional challenge. On average, workers with low incomes or low education or both die younger than those at higher income or educational levels and thus receive government pension benefits for fewer years.

Many countries have instituted early retirement programs for manufacturing or other workers who do manual or physically demanding work because of the perception that it is difficult for such workers to continue beyond their mid-50s.

In addition, in Europe early retirement has often been a way to restructure industries with declining employment, and in the United States it has similarly been offered to unionized workers in industries such as auto manufacturing and steel, where the unions bargained for early retirement and health care.

Aside from unions, however, whose numbers have dwindled drastically, there are no such provisions in the United States. Social Security allows early retirement but only with a reduction in monthly benefits.

Peterson Institute for International Economics | www.petersoninstitute.org

OECD public-sector employees generally enjoy better pensions and are older than those in the private sector. Partly as an intentional outcome of personnel management and human resource policies, government employees across the OECD typically enjoy lower retirement ages and higher replacement rates than available to the general public. Government workers are also typically older than the average workforce. This is especially true for state and local government employees in the United States.

Substantial underfunding of pension promises exists among some US state and local governments, and potentially even larger unfunded health care–related expenses will soon be added. The funding levels of US state and local government pension funds vary from extreme underfunding (funding ratios of less than 20 percent in 2006) to significant overfunding. Thus no general public pension funding crisis exists in the United States, but localized pain may be significant. With the implementation of Government Accounting Standards Board (GASB) Rule No. 45, state and local governments will have to estimate and reveal the extent of their unfunded "other postemployment benefits" (OPEBs), which are overwhelmingly in health care. Some estimates suggest that this may require funding of $500 billion to $1 trillion in additional liabilities for state and local governments. It also seems certain that the impact of the fall 2008 global economic crisis and declining asset prices will put significant additional financial stress on state and local government pension funds.

On the Labor-Market Incentives Challenge

Employment rates of older workers differ significantly by gender and between OECD countries. Employment rates for older male workers declined rapidly in most OECD countries after 1970 but started to rise slowly again in the mid-1990s. But there has been a constant rise in the employment rates of 55- to 64-year-old women, mirroring the rise in overall female labor force participation in the OECD. A few countries, noticeably Japan, did not experience any decline in male employment rates among older workers.

Retirement and tax policies significantly affect employment rates of older workers. This finding is illustrated by the following observations:

- Econometric analysis has found a strong relationship between labor force participation of the elderly and measures of economic incentives.
- There is very little variation across OECD countries in the employment rate of males 25 to 54 years old but large variations for men over 55. Employment rates have declined most in the countries that have increased the availability of early retirement benefits, notably the European economies.

Peterson Institute for International Economics | www.petersoninstitute.org

- A policy change in New Zealand in the 1990s increased the retirement age in the public pension program and resulted in a large increase in the employment rate of older workers. There were no comparable changes for younger cohorts.
- Japan has high employment rates for older men matched by strong incentives to work. The basic government pension is very low, and workers over age 65 do not face a reduction of pension benefits as a result of continued earnings (although a 2004 reform introduced an earnings test for workers aged 65–69 to be phased in starting in 2013).[13]
- The average retirement age in the United States is higher than in most European countries. The US Social Security system is not especially generous, does not allow benefits to be drawn before age 62, and adjusts benefit levels so that the program is roughly incentive-neutral for retirement between 62 and 70.
- Evidence from Sweden indicated that take-up rates for "part-time pensions" were extremely sensitive to the replacement rate offered to beneficiaries.

Older workers in most OECD countries will be significantly better educated. As a direct outcome of rising educational attainment in recent decades, most OECD countries will experience a significant improvement in the educational attainment of their older workers (55–64) in coming decades. This will be less true in the United States, where educational attainment among the same age group is already high and will plateau.

On Individual Account Plans

Policymakers see individual accounts as a way to address the fiscal challenge of retirement plans, improve work incentives, and increase national saving. Policymakers facing budgetary shortfalls in public pension programs and declining rates of labor force participation have been attracted to individual account plans because they can be self-financing. If workers pay in while working and then collect back their contributions (plus interest) in retirement, then the government simply facilitates individual saving for retirement and does not face budget obligations.

Similarly, if workers see that the amounts deducted from their paychecks for retirement are actually going into an accumulating fund from which they will withdraw later, they may view these payments as deferred

13. Employment rates in Japan have been boosted by the fact that many of the elderly were agricultural and rural workers who received lower pension benefits than public and private employees. Cultural factors may also affect Japan's higher employment rates.

Peterson Institute for International Economics | www.petersoninstitute.org

compensation rather than as taxes. When deciding whether or not to retire, workers will trade off the value of a longer retirement against the benefit of accumulating a larger pool of retirement funds to consume once they retire. For policymakers concerned about the impact of taxes in reducing labor supply, this is an advantage.

Increasing the rate of national saving is an objective for many policymakers, and compulsory funded individual accounts can be expected to increase private saving. There is a first-round impact on saving, as contributions to the program add to total saving. This could overstate the final impact as some contributors will reduce their voluntary saving in response to the required program, but the impact will still be positive as workers who would not have saved voluntarily are required to do so.[14] Some workers may add to their voluntary saving as they gain experience as owners of a retirement account.

Individual accounts are not redistributive, often leading policymakers to add provisions to reduce elderly poverty. In a pure individual account system where contributions are a percent of earnings, the distribution of earnings translates directly into a matching distribution of pension receipts. Workers that earn near-poverty-level wages will find that their retirement assets are too small to provide retirement income above the poverty line.

This distributional issue has led to the modification of some individual account systems to assist the poor. In Chile, for example, low-income participants in the individual account system receive the minimum benefit level rather than the amount based on their retirement assets. Many workers participate in the program only long enough to qualify for the minimum benefit or stay out of the program altogether. In the country's recent elections, both main parties promised to provide more support for the elderly poor—and in fact such provisions have now been enacted into law.

In Sweden, there are various provisions to assist those with low incomes, including subsidized benefits for those whose individual accounts are small, as well as housing, health, and transportation subsidies. The individual account proposal by the US administration in 2002 had a provision for low-income workers to continue to receive the level of Social Security benefits that they would have received under the current system.

In practice, therefore, the goals of policymakers in setting up individual accounts are not fully realized. There remains a fiscal burden from supporting low-wage workers. And work incentives are reduced if further contributions to the retirement plan have no impact on future benefits, which are set by the minimum level and not by contributions.

14. If a system of funded individual accounts replaces a PAYGO system, then any reduction of private saving is likely to be minimal, since some individuals may have already offset expected retirement benefits by reduced saving.

Peterson Institute for International Economics | www.petersoninstitute.org

Unfunded plans, proposed as an alternative to the fiscal challenge of replacing a PAYGO pension program with an individual account plan, do not increase saving. Nearly all contributory public pension plans in the OECD have relied on the PAYGO structure. Shifting to individual accounts creates a huge budget challenge because of the obligations to existing retirees and workers who have made contributions. A few countries, such as Australia, have met this challenge by using general tax revenues to pay past obligations and funneling new contributions to individual accounts invested in private stocks and bonds. Others have opted for unfunded plans in which new contributions are credited to individual accounts but the money is actually used to pay past obligations (e.g., Latvia and Sweden, both of which also have small funded accounts).

Unfunded individual accounts can change the work incentive for beneficiaries, creating a tight link between contributions made while working and benefits received in retirement. These accounts also face the same distributional issue as funded accounts. And, since no funds are invested in real assets, there is no increase in saving from these programs.

Individual accounts are a way to frame the policy debate. Several countries found a sustainable solution to their pension funding shortfalls by introducing individual accounts. The best such example is Sweden, where the policy change (to unfunded individual accounts) was debated and widely understood, paving the way for adoption of a "balancing" formula that will adjust pensions in the event of funding shortfalls. Chile and Mexico also have replaced failing public pension plans with individual accounts and created sustainable retirement assets for the middle class. In Italy, on the other hand, the individual account plan was not understood, and implementation was de facto postponed well into the future.

Administrative costs for privately managed individual accounts are high. The experiences of Chile and Mexico show that the administrative costs of privately managed funded individual accounts have been very high, sharply reducing effective returns to contributors, particularly those with low wages and low contribution levels (the real rate of return on the largest fund asset in Chile averaged 10.2 percent per year in 1985–2002, while returns accruing to participants averaged 4.3 to 6.9 percent). There is a very strong case for pooling contributions before passing them on to private investment managers, as is done for the funded portion of the Swedish retirement program.[15] Chilean pension funds have also had high marketing expenses.

15. According to Turner (2005), administrative costs in Chile averaged 1.4 percent of account balances as of 1998, while those in Sweden averaged 0.95 percent as of 2000. Of the 0.95 percent in fees in Sweden, 0.3 percent goes to the central government agency that pools the individual contributions.

Peterson Institute for International Economics | www.petersoninstitute.org

Competition among fund managers did not lower administrative costs in Chile or Mexico. The government of Chile wanted to use competition among different funds to lower both administrative and marketing costs of the public pension program, recognizing that high costs would substantially lower returns, especially for low-wage workers with small contributions. This did not happen. Instead, the funds competed against each other in their marketing efforts and costs remained very high. A similar experience occurred in Mexico.

We found no evidence of excessively risky investments by participants. We did not find examples where participants had made rash investment decisions and incurred losses on their accounts. In most plans the investment choices have been constrained, often to investments in safe bonds, although many plans (notably in Chile) are increasing the range of choices. The United Kingdom had individual accounts available to public pension participants during the technology bubble, but, after looking at the policy literature and press reports and contacting experts on the UK program, we found no evidence of people having lost a disproportional amount of money on speculative investments in the UK individual accounts program.[16]

Allowing retirees with individual accounts to withdraw the funds in a lump sum creates serious problems. Australia allows lump-sum withdrawals, and many participants take advantage of this option, generally to reduce their debts or finance living expenses for early retirement. Then, once they reach the official retirement age, having exhausted their personal retirement savings, they apply for the means-tested minimum public pension and get it because they have little or no other income at that point (Australia exempts the value of the primary residence from the means-testing). Effective regulation could avoid this problem by requiring the purchase of annuities, as is done in some countries.[17]

The distributional problem in individual account plans has been difficult to solve. In Chile, the distributional problem has resulted in a high dependence on the minimum pension provision, which is too low to prevent elderly poverty. Even though the individual account system is required of employees, many workers in Chile either do not participate or participate only long enough to qualify for its minimum pension and then move into

---

16. However, there was a scandal in the United Kingdom because financial institutions advised people to withdraw from the state PAYGO plan and create individual accounts when this was not in their best financial interests.

17. There are alternatives to annuities with similar results—programmed withdrawals, for example.

Peterson Institute for International Economics | www.petersoninstitute.org

self-employment or the informal sector. Sweden prevents elderly poverty by providing low-wage workers with retirement support beyond the level justified by past contributions, although many retirees face a very high implicit tax rate (48 percent) on other income received in retirement.

Individual account plans do not solve or obviate problems created by political pressure groups. Individual accounts appear to be a politically feasible way to deal with failing pension plans and/or the funding crisis created by demographic change, but political pressures do not disappear. Public-sector employees in Latvia, for example, were able to negotiate a special retirement deal that has partly undercut the introduction of individual accounts, and pensions for the armed forces in Chile were exempt from the individual account plan.

Evidence on the question of whether funded accounts increase national saving is positive but thin. There is pretty solid evidence that the introduction of funded individual accounts in Chile, which has the longest-running funded plan, increased the national saving rate. But it would be nice to get corroborating evidence elsewhere. Australia, Canada, and the United Kingdom have not seen clear signs of increased saving, although their programs may be too small, have design problems, or not have been in place long enough.

There have been administrative problems in individual accounts in some countries, but not broadly. The introduction of individual accounts has generally been free of administrative problems, but there are a few exceptions (e.g., Hungary, Mexico, and Poland). Latvia is also an exception, but this is because of its transition economy and the loss of past employment records. It appears that individual accounts are feasible in most advanced economies with good record keeping and computerized systems.

On Corporate Pensions

Coverage rates for employer-funded private pensions in America have remained roughly stable since the 1970s, but coverage has shifted away from defined benefit plans. Private employer-sponsored pension programs were never a universal part of the labor market. These programs typically covered higher-wage white-collar workers and union workers, who were only a fraction of the workforce. Furthermore, the decline in coverage of such programs for males has been offset by an increase in coverage for females, so that the proportion of the US workforce covered by such plans has not fallen by much. About 25 percent of the workforce had company pension plans in 1960; this figure rose to slightly below 50 percent by the late 1970s and was still at about that level as of 2006. The decline in

Peterson Institute for International Economics | www.petersoninstitute.org

unionization has resulted in a decline in pension coverage for blue-collar workers, and there has also been a substantial shift to defined contribution plans and away from defined benefit plans.

Only a minority of those over 65 receive any private pension income. The fraction has been rising slowly but remains well below 50 percent. In 1975, in the bottom three quintiles of the income distribution for persons over 65, only about 2, 5, and 18 percent, respectively, received *any* income from private pensions. Even for the top income quintile the figure was only around 45 percent. By 2005, these figures had risen to around 5, 10, and 25 percent, respectively, for the lower three quintiles and about 55 percent for both of the top quintiles.

Private corporate pensions were often introduced as supplements to Social Security. Corporate pensions, introduced during and after World War II, were often closely tied to the provisions of Social Security. Many were "top-up" plans, in which the company agreed to ensure that the retiree had a certain level of income, based on Social Security and a company supplement if the government benefit fell below the agreed amount. Any increase in Social Security benefits would then be matched by a decrease in the employer contribution.

To a greater extent than in most other countries, the United States encourages tax-advantaged private retirement saving and has a larger stock of private pension wealth than any other economy. This finding may seem inconsistent with those above, but it is not, because the private retirement wealth is held mostly by higher-income workers, a small fraction of the US population. The OMB estimated that the tax revenue loss from private pension provisions in 2005 was over $100 billion.[18]

By 2006, US corporate defined benefit pension plans had returned to solid funding levels. By 2006 the so-called perfect pension fund storm of declining stock prices and record low interest rates in the early 2000s had passed. The overall funding level for the largest US corporate pension plans in S&P 500 had returned to full funding by then.[19] However, corporate pension plan funding levels remain volatile, and the impact of the fall 2008 global economic crisis on funding levels is likely to be dramatic. The OECD (2008) estimates that the total decline in OECD pension fund assets from December 2007 to October 2008 reached $3.3 trillion, of which $2.2 trillion occurred among US pension funds alone.

18. This is a tricky calculation because tax receipts are lower at the time income is sheltered but higher at the time it is withdrawn. See OMB (2007).

19. The adequacy of funding for pensions depends on the discount rate used, which can be volatile.

Peterson Institute for International Economics | www.petersoninstitute.org

Nearly all US defined benefit plan terminations are voluntary, and only a very small number of very high–income Americans have lost any pension benefits as a result. Of the defined benefit plans terminated in the United States since 1974, 98 percent have been voluntary and without any loss of workers' pension benefits. Only a very small number of Americans (those with defined benefit pensions about four times the average Social Security benefit) have experienced any loss of benefits.

The financial situation of the Pension Benefit Guaranty Corporation (PBGC) is stabilizing, and the corporation has successfully sheltered covered American workers against pension benefit losses, but it is declining in importance. The level of "reasonably possible" liabilities for the PBGC fell by $46 billion to $62 billion from 2005 to 2007, reflecting the overall improvement in US corporate defined benefit plan finances. Combined with the reforms of the PBGC included in the 2006 Pension Protection Act (PPA), this puts the PBGC in a relatively good position to weather the impact of the 2008 global economic crisis on corporate pension plans. The share of US workers covered by the PBGC is declining rapidly as defined benefit plan provision becomes rarer.

Long-term trends, rather than short-term financial pain, explain the switch from corporate defined benefit pension plan provision in the United States. Rapidly rising administrative costs, longevity risk, shifts in accounting rules toward more transparency, asset-liability mismatches, and the advantages in a flexible work environment of defined contribution plans all explain the shift from corporate defined benefit pension plan provision in the United States. Also, many workers do not expect to remain with the same firm long enough to receive pensions from defined benefit plans.

The shift from corporate defined benefit plans is a global one, as financial troubles in such plans have been widespread among the major industrialized economies. Corporate defined benefit pension plans in Canada, Germany, Japan, and the United Kingdom have experienced many of the financial and funding problems seen among US corporations. The prolonged stagnation in Japan in the 1990s even necessitated a government rescue of the country's corporate defined benefit plans, which saw up to $120 billion of hitherto private corporate pension plan assets and an unknown (but significantly higher) level of corporate pension plan liabilities transferred to the Japanese government. In most industrialized countries corporations are shifting away from defined benefit pension plans for the same reasons as are US corporations.

Many OECD countries have had corporate pension plans based solely on defined contribution benefit provision for many years. Unlike in the United States, where corporate pension schemes were traditionally of the defined benefit type and have only relatively recently shifted toward

Peterson Institute for International Economics | www.petersoninstitute.org

defined contribution/hybrid schemes, several OECD countries with large-scale corporate pension schemes have relied solely on defined contribution pensions for decades.

US corporations have experienced no relative competitive disadvantage vis-à-vis companies in other major industrial nations from their pension commitments. As defined benefit plans and associated financial trouble have both been widespread across companies in major industrialized nations, pension liabilities in US corporations have not created any particular competitive disadvantage. Instead, any such disadvantage for US corporations is related primarily to health care.

Policy Implications

Lessons from Overseas Do Not Suggest a Need for Major Reform in the United States

There is always a good deal of stickiness in the policy environment, and it is rare that policymakers succeed in upending the policy cart and changing a system. For example, President Bill Clinton's attempt at major reforms in the US health care system went down to defeat in the 1990s. And the Bush administration's attempt to introduce individual Social Security accounts made no progress even though the proposal was for a voluntary program. Looking overseas we see similar resistance to change. The countries that have instituted major reforms (Australia, Chile, Italy, Latvia, Mexico, Poland, Sweden, and the United Kingdom), particularly those that have introduced individual accounts as replacements for PAYGO plans, have faced substantial budget problems in their pension programs and in many cases were undergoing major economic transformations. And even in these countries there has been a fair amount of backtracking from a purely contributory individual account plan as they face the problem of low-wage workers that drop out of the system and end up in poverty or on a minimum pension program.

Given the political difficulties involved, is it worthwhile to attempt a major overhaul of the US system? Several of our findings are relevant to the answer, specifically those that relate to the fiscal shortfall, labor force participation, the saving challenge, and the distributional challenge.

First, the fiscal problem with the US Social Security system is not very large, so major reforms are not necessary to deal with it. Instead, incremental changes to benefit levels, taxes, or retirement ages would restore solvency to the program. This contrasts with the situation for pension programs in other countries (and with the US Medicare program), where the projected funding shortfalls are huge.

Peterson Institute for International Economics | www.petersoninstitute.org

Second, the structure of the Social Security program allows participants to retire before the normal eligibility age for a full pension at age 65, but it does not give them an economic incentive to do so. Participants are free to choose their retirement age beyond the minimum age of 62 but with benefit levels adjusted for age of first benefit receipt. This contrasts with many European countries, where public pension programs have often subsidized early retirement.

The third point is more nuanced. The current Social Security system does not add to national saving; indeed, it may reduce it to the extent that participants count on public benefits and fail to save on their own. In addition, the United States is generally a low saving economy (independent of retirement planning); in fact, the national saving rate is almost certainly too low. So, in principle, a major reform of Social Security that raised the national saving rate would have merit. But this is not a compelling argument for major reform because there is no feasible plan on the table for Social Security reform that would add to national saving. An unfunded system like that in Latvia, Poland, and Sweden does not increase saving. The Bush administration's proposal for individual accounts and increased government borrowing would not increase saving. A major reform that would increase saving would replace the current system of PAYGO benefits with individual accounts and increase taxes to fund obligations to workers who have paid into the old system. But there is (as yet) no widespread support for this approach. Thus, although policies that would increase national saving in the United States are desirable, major reform of Social Security is not a promising way to achieve this goal.[20]

Finally, there is the distributional issue. The US Social Security program leaves some retirees at or below the poverty line. The persons with the highest poverty incidence are widows, particularly those over 75. There is bipartisan agreement on the need for reforms that improve the situation of the elderly poor: Liberal reformers recognize the need for higher benefits for this group (e.g., the proposals in Diamond and Orszag 2005), and the Bush administration's plan also indicated the need to address the problem.

This problem is not unique to the United States but is not widespread among advanced countries. Most European countries provide

20. The only country that has used public pension reform as a way to increase national saving is Chile. Latvia, Poland, and Sweden introduced small funded individual accounts as add-ons to their unfunded account programs and these may have increased national saving. See the discussion below for the case for add-on individual accounts. Mexico may be another example like Chile. Increasing saving was not primary motivation for reform in Chile or Mexico. The United Kingdom under Margaret Thatcher introduced major reforms of its public pensions, making the program substantially less generous and creating optional individual accounts. This was part of a package of extensive economic reforms but has not resulted in a large increase in national saving (although it helped the overall budget).

Peterson Institute for International Economics | www.petersoninstitute.org

more generous income support to the poor than the United States. However, Chile and the United Kingdom introduced pension reforms that leave too high an incidence of elderly poverty, indicating a need for modifications to the reform package. We saw no country with a major reform of public pensions whose principal goal was to make the program more redistributive. Realistically, that is not going to happen in the United States either, although a distributional improvement, as part of an incremental package dealing with the funding shortfall, should be possible.

The conclusion of this section is, therefore, that the experiences of other countries do not support an overhaul of the US Social Security program. The reason for most major reforms in other countries is that their pension programs were in severe budget crisis and/or labor force participation was low or declining. These arguments are not as compelling for the United States, where the funding shortfall is not great and employment incentives in the existing program are pretty good.

Variable Life Expectancy and Early Retirement

We report that life expectancy varies by income and education and that low-income and less educated (frequently manual) workers draw retirement benefits for fewer years. Does that mean these workers should be allowed to retire earlier or receive higher benefits when they retire?

Intuitively, it may seem sensible to say that workers who are likely to die younger than the average should be compensated by receiving higher monthly retirement benefits while they are alive. From the perspective of economic theory, however, this intuition is not valid. First, many characteristics influence life expectancy, including race and gender. Should women receive lower monthly benefits than men because they have a longer life expectancy? Should African-Americans receive higher monthly benefits than whites because their life expectancy is lower? Providing different benefit levels based on personal characteristics would open up many tough issues, such as who qualifies for favorable treatment and why.

More generally, in an economic model in which people's well-being or utility depends on their consumption, it is easy to conclude that social programs that protect against low consumption are a form of insurance against adverse outcomes and can make society better off. It is much more difficult to make the case that those likely to live longer should face lower consumption levels.

In our cross-country comparisons we did not find examples of mandatory pension programs for the general population that gave higher benefits to those expected to die early. Indeed, in the countries that do discriminate among recipients, women are given more favorable treatment,

Peterson Institute for International Economics | www.petersoninstitute.org

being allowed to retire at a younger age, even though they are expected to live longer. But retirement differences between men and women are being phased out.

In light of these observations we conclude that there is not a case for giving higher or lower benefits based on expected lifetime.

The question of allowing workers with physically demanding jobs to retire early is more difficult. It is not hard to create a model in which people whose jobs become harder to do as they age would choose to retire at a younger age, and an ideal pension program would take this into account. For example, someone who is skilled at moving heavy furniture would likely choose to retire younger than someone skilled at sitting at a computer and writing research reports like this one. Many European economies have created special early retirement programs geared loosely to those who work with their hands. As noted above, however, such programs have been in response to union resistance to restructuring or privatization.[21] Many European countries also have generous sickness and disability benefits that serve as early retirement programs for manual workers.

In the United States there are no government-sponsored early retirement plans,[22] although private companies do use buyouts to reduce employment. Much more so than in Europe, in the United States there is a view that an individual who is laid off from a job, or who cannot continue in a job because of its physical demands, is expected to take a different job, even if it is at a lower wage.

The experience of other countries does not provide compelling guidance about how to address this issue. European policymakers are generally trying to increase the retirement age and reduce the number of people collecting early retirement, and many countries are trying to rein in spending on disability programs. It is very difficult, indeed perhaps impossible, to determine objectively how fit people are to continue working as they age, and this means that workers with leverage or persistence or who find doctors willing to vouch for disabilities often get more generous treatment. The research in this project was not aimed at disability programs, but the conventional wisdom says that the US disability program gives benefits to some who are not really disabled and denies benefits to some who are. The feature of the US Social Security retirement program that allows people to retire "early" at 62, with a penalty, may be the best policy.

---

21. Renault, the French auto company, had to restructure in order to compete effectively when the European Union allowed open competition. The state-owned company was being prepared for privatization (with some remaining state ownership) and the government subsidized early retirement programs in order to reduce the workforce. Renault closed its plant in Belgium and gave employees early retirement, including workers as young as 48!

22. There is, however, a Social Security disability program, which generally makes payments to persons who have been in the lower-wage segment of the labor force.

Peterson Institute for International Economics | www.petersoninstitute.org

Increases in Life Expectancy and Retirement Age

Every advanced country has experienced increases in average life expectancy, a boon that carries with it the penalty of higher pension obligations. Economic analysis does not speak unequivocally as to whether people should work longer if they live longer. Holding overall earnings constant, it is very likely that people who make rational saving and retirement decisions would respond to a longer expected lifetime by saving more while working and by working for more years. Offsetting this, however, is the fact that incomes and living standards are rising, and time spent in retirement becomes more affordable as incomes rise (retirement was not an option for many workers in the 19th and early 20th centuries).

Most of the OECD economies are only now starting to respond to pension budget pressures by pushing up official retirement ages, arguing that because people are living more years, they should also work more years so that they can sustain their income in retirement. Over the past 30 years, European countries have drastically reduced the number of hours per year worked by those who are employed and have greatly increased the number of workers given early retirement. The policy changes that made this possible were based partly on the illusion that such measures would lower unemployment rates among the general population. Today, this trend is gradually being reversed in Europe through the realization that there needs to be an increase in employment or hours to pay for all the benefits that have been granted. Almost all recent pension reforms have therefore included either prefixed increases in eligibility ages for early or full pensions or direct life expectancy links. As we describe in chapter 8, we believe that additional direct linkages to life expectances should be part of any reform of Social Security, too.

The Case for Add-On Individual Accounts

In our assessment of the Bush administration's plan for individual accounts, we find that the plan's design features dealt effectively with many of the problems seen in other countries. In particular, investors would be given the choice of a limited selection of funds modeled on the current federal retirement plan, the Thrift Savings Plan. This would mean that savers would not be tempted by rash or unsound investments and would be encouraged to develop safer portfolios as they came closer to retirement. Participants would be required to purchase annuities on retirement and not be allowed to withdraw their funds in a lump sum.

The administration plan did not define the extent to which the government would provide administrative services to individual accounts, although there was clearly an awareness that competition among providers might not result in low administrative costs. Based on the experience in

Peterson Institute for International Economics | www.petersoninstitute.org

the United States and other countries, we have argued here that a centralized governmental authority would have an advantage in lowering administrative costs. The Social Security Administration runs very efficiently, inasmuch as its total costs are a very small percentage of its benefit payout. It could provide a pooling service to individuals who chose to participate in an individual account plan in addition to Social Security. Much of the necessary record keeping would already be in place. By providing such services, a governmental authority could give an effective subsidy to low- and moderate-income participants, who would not be charged the full amount of the administrative costs that their accounts incurred.

There is traditionally in America considerable political concern about a governmental authority investing in private-sector assets. However, if the Social Security Administration were to operate the bookkeeping part of an individual account plan, it could still be precluded from making investment choices or holding stocks or bonds or voting on company decisions. The contributions of individual account holders would be assigned to the funds the holder had chosen and the money would then be pooled and sent to private investment managers to invest in the markets. An independent advisory board would be responsible for the selection of investment managers, who would be subject to careful rules.

We have explained why we believe that the lessons from other countries do *not* suggest that the US Social Security system should undergo a massive design change or overhaul. It works pretty well compared with other countries' retirement plans. Why, then, create an add-on plan of individual accounts? Because we found that countries that had adopted individual account plans had achieved a considerable measure of success with these plans. Individual accounts work. In the United States, almost all academics have individual account plans that provide, or will provide, the bulk of their retirement income and they are pretty happy with the results.[23] For those less confident of their ability to make investment choices, the plan could offer advice, limited choices, and a well-balanced default option.[24]

The four main flaws of the 2005 Bush Social Security plan were: (1) It was not expected to remain solvent, (2) it did not result in additional saving and may even reduce national saving, (3) it did not provide very generous retirement benefits to most recipients, and (4) it left too many recipients, notably elderly widows, in poverty. An add-on individual

23. Academics are not necessarily more knowledgeable than others when it comes to portfolio choice. The story has been told about two Nobel prize winners in economics who were asked for advice about allocating funds between stocks and bonds in the academic pension program TIAA-CREF. "Oh, 50–50 is a good rule" was the response.

24. Most participants in the Swedish individual account plan take the default option suggested by the program.

Peterson Institute for International Economics | www.petersoninstitute.org

account plan would address two of these flaws—(2) and (3)—and it could be designed to address (4) by, for example, giving each child born in the United States an individual account of, say, $1,000. An individual account plan would not deal with the solvency problem, but it would add to national saving and result in more retirement money for low- and moderate-income participants.

Or there could be alternative policies to lower elderly poverty, by making the SSI program more generous, for example. How large? Compulsory or voluntary? Our research does not provide clear answers to these questions. Larger contributions—say, 5 percent of wages up to a dollar limit—would increase the size of accounts and lower the ratio of administrative costs relative to contributions. Thus there would be a meaningful increase in national saving and in the funds available at retirement; low- and moderate-income workers would have higher pension benefits; and workers who retire at 62 because of reduced physical or mental capacity would still have enough money for a basic retirement income.

On the other hand, a smaller or voluntary contribution would be more politically acceptable. Introducing a compulsory contribution of 5 percent of wages would be noticed as a drop in workers' take-home pay. There would be complaints about higher "taxes" even though this would not be a tax in the usual sense. This argument seems strong enough to make the case that initially an add-on program should be voluntary with contributions up to a limit. Over time, if it became popular, contributions could become compulsory, unless the individual already had an adequate employer-provided plan. Because the participation rate is much higher if contributory pensions are set up as "opt-out" rather than "opt-in," the national plan could be set up so that workers are automatically enrolled unless they choose to opt out.

Lessons from Other Countries for Dealing with the Solvency Issue

Two lessons stood out from this research. First, increasing the retirement age is a very powerful tool to restore solvency and is strongly suggested by the increase in life expectancy in all advanced countries. As it is, governments around the world have been dealing with their fiscal solvency issues by "selectively defaulting" on some of their liabilities toward younger retirees.

Second, the United States has a much wider distribution of income than other countries. The average income level of persons over 65 is pretty high in international comparison—82 percent of the national average (Förster and Mira d'Ercole 2005)—but there is much variation in the distribution of this income. A large group of low- to moderate-income retirees depends heavily on Social Security benefits that are not terribly generous, whereas higher-income taxpayers can shelter substantial amounts of

Peterson Institute for International Economics | www.petersoninstitute.org

money through 401(k) plans, employer-funded plans, and in some cases deferred income plans (in which executives are paid in options or restricted stock units that are not taxed until withdrawn). We have also found that the finances and funding of corporate pension plans are relatively secure, so this stream of income to high-income people looks set to continue. The capital gains tax is also very low in the United States, allowing high-wealth individuals to pay a low tax rate on an important component of their income; for example, the capital gain on a principal residence is exempted from tax up to $500,000 for a married couple, a tax break that can be taken repeatedly.[25]

Given these observations, we conclude that the main avenues to restore solvency to the Social Security program are to continue to gradually increase the retirement age and to reduce the level of Social Security benefits paid to high-income or high-wealth recipients.

Prefixed increases in the normal retirement age are already in effect until 2027. We propose that this gradual rise in the eligibility age for a full Social Security pension continue and be tied to rises in life expectancies beyond the legislated increases in retirement ages to 67 by 2027. This is most appropriately achieved by fixing the fraction of Americans' lifetime spent in retirement to total life time at historical levels.

In terms of lowering benefits for high-income individuals, we argue that taxpayers who have taken advantage of tax sheltering opportunities for their personal retirement savings should face an automatic markdown of their expected publicly provided Social Security benefits. We make the case for this policy in chapter 8, pointing out the large discrepancy in tax-sheltered wealth across income categories and the fact that the United States stands out from other OECD countries in its tax treatment. Critics of this proposal may argue that we are taxing savings and that this is a mistake in an economy that is short on saving. Our view is that the low saving rate is a problem primarily for lower-income families that typically do not have large private pension funds. In addition we do not propose completely eliminating the tax break for saving. Moreover, most taxpayers will take a "bird-in-the-hand" tax break now rather than worry about a modest reduction in future Social Security benefits. So the impact on private saving is likely to be modest.

The wide distribution of income before and after retirement in the United States compared to other countries further bolsters the case for reducing benefits to high-income retirees rather than across the board. Based on evidence from other countries, we do not believe that the increase in the progressivity of Social Security will lead to any decline in the broad political support for the program in the United States.

---

25. Capital gains on assets held in tax-preferred pension plans are tax exempt until withdrawal, when they are taxed as ordinary income.

Peterson Institute for International Economics | www.petersoninstitute.org

References

Barr, Nicholas, and Peter A. Diamond. 2008a. *Reforming Pensions.* Working Paper 08-22. Cambridge, MA: Massachusetts Institute of Technology, Department of Economics.

Barr, Nicholas, and Peter A. Diamond. 2008b. *Reforming Pensions: Principles and Policy Choices*. New York and Oxford: Oxford University Press.

CBO (Congressional Budget Office). 2008. *Accounting for Sources of Projected Growth in Federal Spending on Medicare and Medicaid*. Washington. Available at www.cbo.gov.

Diamond, Peter A., and Peter R. Orszag. 2005. Saving Social Security. *Journal of Economic Perspectives* 19, no. 2 (Spring): 11–32.

Förster, M. F., and M. Mira d'Ercole. 2005. *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s.* OECD Social, Employment and Migration Working Paper 22. Paris: Organization for Economic Cooperation and Development.

Gruber, Jonathan, and David A. Wise, eds. 1999. *Social Security and Retirement Around the World*. Chicago: University of Chicago Press.

Holzmann, R. et al. 2005. *Old-Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform.* Washington: World Bank.

McKinsey Global Institute. 2008. *Talkin' 'Bout My Generation: The Economic Impact of Aging U.S. Baby Boomers.* San Francisco: McKinsey & Company.

OECD (Organization for Economic Cooperation and Development). 2008. *Pension Markets in Focus,* no. 5 (December). Paris.

OMB (Office of Management and Budget). 2007. *President's Budget 2008—Analytical Perspectives*. Washington: Executive Office of the President.

Penner, Rudolph G., ed. 2007. *International Perspectives on Social Security Reform*. Washington: Urban Institute Press.

Queisser, Monika, and Edward Whitehouse. 2005. Pensions at a Glance: Public Policies Across the OECD Countries. Presentation at the Organization for Economic Cooperation and Development, Washington, June 17. Available at www.oecdwash.org.

Sartori, Giovanni. 1996. Comparing and Miscomparing. In *Comparative Politics: Notes and Readings,* 8th ed., ed. Roy C. Macridis and Bernard E. Brown. Belmont, MA: Wadsworth Publishing Co.

Turner, John. 2005. *Administrative Costs for Social Security Private Accounts*. Research Report (June). Washington: AARP Public Policy Institute.

Whitehouse, Edward, OECD (Organization for Economic Cooperation and Development), and World Bank. 2007. *Pensions Panorama: Retirement-Income Systems in 53 Countries.* Washington: World Bank.

Peterson Institute for International Economics | www.petersoninstitute.org