8

Conclusion

It is essential that we maintain both the forward momentum of economic growth and the strength of the safety net beneath those in society who need help. We also believe it is essential that the integrity of all aspects of Social Security are preserved.

—Ronald Reagan, acceptance speech at the 1980 Republican Convention, July 17, 1980

Based on our analysis of pension reforms in other countries, we conclude that the US Social Security retirement system compares favorably with the systems in other advanced economies and indeed is better than most. Two of its virtues are its modest scale (thus it does not displace a lot of private saving) and its adjustment of benefits based on age of retirement (thus it does not encourage early retirement).

But there are also concerns about the program. First, it is not financially sustainable and is likely to run out of money as the baby-boomer generation retires and lives longer than earlier generations. This is an important problem, although in comparison with many other countries the fiscal challenge for Social Security is not overwhelming; recent estimates released by the Congressional Budget Office (CBO 2008) as this book was being completed in the fall of 2008 suggest that the fiscal shortfall is only about 1 percent of payroll, less than had been thought (the earlier figure was 1.8 percent). In other words, an increase in Federal Insurance Contributions Act (FICA) taxes by 1 percentage point would restore Social Security to a 75-year balance (this is a way of measuring the size of the shortfall and does not necessarily mean that higher payroll taxes are the best solution).

Second, Social Security is not particularly redistributive, in contrast to the retirement programs of other English-speaking countries. This does not mean, however, that there should be an increase in the average size of re-

tirement benefits. Indeed, based on our research and the broad literature on US policy, we conclude that US public support programs are rather more generous to the elderly than they are to younger generations (largely because of Medicare and Medicaid). As many analysts have acknowledged, the distributional issue for Social Security is that upper-income retirees get too much and lower-income retirees too little. The Bush administration proposal for individual accounts recognized the need for additional help for poor elderly Social Security participants; Peter Diamond and Peter Orzsag (2005) have described the poverty risks of elderly widows who rely on Social Security; and Peter G. Peterson (2004) has pointed to the relatively generous benefits for upper-income retirees. In short, there is scope to make the US retirement benefit structure somewhat more progressive.

Third, Social Security does not contribute to national saving—indeed, it may reduce it, to the extent that it discourages private saving. This is an important concern because national saving overall is low in the United States, many American households save little or nothing for retirement and end up dependent on Social Security benefits, and many of the elderly have few financial assets or resources to fall back on when unexpected spending needs arise.

The second and third concerns are relevant to the question of whether there should be a program of individual retirement accounts in the United States. As requested by the Ford Foundation, which funded this research, we examined countries that have adopted such accounts, and we learned much from their experience with these accounts (see chapters 1, 5, and 6). We found that there are two important advantages to such plans. First, as a political tool, they compel people to recognize the link between how much they contribute and how much they draw out. Second, they increase national saving, an advantage in economies that are saving too little, of which the United States is certainly one. The disadvantages of such plans are, first, that they are not at all redistributive but simply translate differences in work-related income into differences in retirement assets. Given the trend in US data showing a substantial widening of the wage and income distribution, we consider this a serious drawback. The second disadvantage concerns transition: Going from a long-established pay-as-you-go plan to a funded individual account plan involves either raising taxes to support the transition (borrowing to do so) or operating a notional plan of the type developed in Sweden. These options are politically easier but reduce or eliminate the advantage of increasing national saving.

Given the disadvantages of replacing the current Social Security program with individual accounts, and given that the current program compares favorably with public pensions in other countries, we conclude that the introduction of an individual account plan to displace the current program is not justified. However, we have been sufficiently impressed by the benefits of individual accounts as they have been used by other countries to suggest that such a program could supplement Social Security,

serving mostly low-income savers that do not participate in employer-funded pensions or 401(k) plans. The program would address, in part, the very low national saving rate and the fact that so many households in retirement or approaching retirement have very few financial assets to cover unexpected expenditures.

In this chapter we present our ideas for tackling the key problems facing US Social Security—fiscal imbalance and a lack of adequate household saving. Our ideas are informed and influenced by our research and do not necessarily reflect the views of the Ford Foundation. We believe our reform proposals, if rapidly implemented, would further send a powerful and beneficial signal around the world that America is now determined to address the long-term challenges facing the country.

Based on our assessment of pension reforms in other countries as well as in the United States, we conclude that no single policy tool is sufficient to sustainably "fix" any pension system. The inherent complexity of such systems and the required broad political backing for any reform to work in the long run require the simultaneous use of different policy tools to "distribute the reform pain" across both pension contributors (taxpayers) and beneficiaries (current retirees). The goal is to find a way to put the Social Security retirement program on a sustainable path in a manner acceptable to the broadest possible coalition of constituents.

We, therefore, present four interconnected reform proposals. To deal with the fiscal shortfall, we propose

1. targeted benefit adjustments that better integrate Social Security with private, tax-advantaged pension plans;
2. continued adjustments of the normal retirement age after 2027; and
3. increased Social Security revenues to cover any additional requirements to shore up the program's long-term sustainability.

And to respond to the low saving rate, we propose

4. a system of add-on individual accounts.

Targeted Benefit Adjustments to Deal with the Fiscal Shortfall

Average benefit levels in Social Security are not very high by international comparison, and yet American retirees rely heavily on them for their cash income. Benefit cuts should, therefore, target higher-income rather than lower-income participants. In his book *Running on Empty*, Peter G. Peterson (2004) asks why on earth Social Security is paying benefits to him. Few retirees are as wealthy as Peterson, but many have good incomes and a strong asset base and do not need generous Social Security benefits. In

practice, however, these individuals or families do receive pretty generous benefits[1] because they had high income levels for much or all of their lives.

That line of argument suggests that means testing might be appropriate for Social Security benefits, with lower benefits paid to those with higher incomes or higher wealth, a suggestion that takes us back to the discussion of the philosophy behind the program. The Social Security program (as opposed to Supplemental Security Income [SSI]) was introduced by President Franklin D. Roosevelt as a contributory system like the German pension innovation of the late 19th century. The rich get more because they have paid in more.

There are redistributive aspects to the program, so it is not a purely German model, but means testing would represent a major shift that would arouse concern among the program's supporters. One danger of moving to a means-tested program is that over time, it may be perceived as a welfare program and lose its popularity. In our research on other OECD countries we found no evidence of massive public opposition to much more redistributive systems than Social Security, so we are not sure how serious a problem it would be in the United States, but we acknowledge that it would likely motivate opponents of explicit means testing in this country.

There are several ways to make Social Security more progressive without explicit means testing—for example, by taxing 100 percent of benefits (as other OECD countries do; see chapter 2) or increasing the earnings limit on FICA taxes; we do not review them all as our research did not provide additional insight beyond what is already available in the policy literature. Based on what we have learned, however, we do want to make the case that US policymakers should evaluate the large tax breaks for deferred income, including pension contributions. People who have been the beneficiaries of such tax advantages may not need—especially in times of strained government resources—full Social Security benefit levels. Our proposal would function as an implicit cut in the current government subsidies to pension savings through tax provisions.

Integrating Social Security Benefits with Tax-Preferred Private Pension Accumulation

We propose to cut benefits by linking, or integrating, the Social Security benefit that individuals will receive from the public Old-Age, Survivors, and Disability Insurance (OASDI) fund with the funds the same individuals have placed into tax-advantaged private pension savings. The latter include employer pension contributions, which are not counted as part of employees' taxable income, plus individual contributions to 401(k)

1. For example, high-income married couples are entitled to monthly benefits of around $3,500 a month, well above the average benefit level.

plans or individual retirement accounts (IRAs), which can be deducted from earnings in computing taxable income. Other forms of deferred compensation, such as awards of restricted stock or stock options, are excluded from income until the stock is converted into marketable securities. The impact of integration for workers who made extensive use of tax breaks for their individual pension savings would be a reduced Social Security pension.

The integration of public and private pensions has a history in the United States. As we noted in chapter 7, private (corporate) pension benefits were often adjusted depending on an individual's level of Social Security benefits—the corporate pension would "top up" the Social Security benefit. We propose something with a similar intent: to make sure people have enough to retire but not provide more than is needed. The big difference is that, historically, the company pension plan benefited from the integration, whereas with our proposal, the Social Security Trust Fund would benefit, an arrangement that would also benefit retirees without significant private pension wealth through the preservation of their Social Security benefit levels.

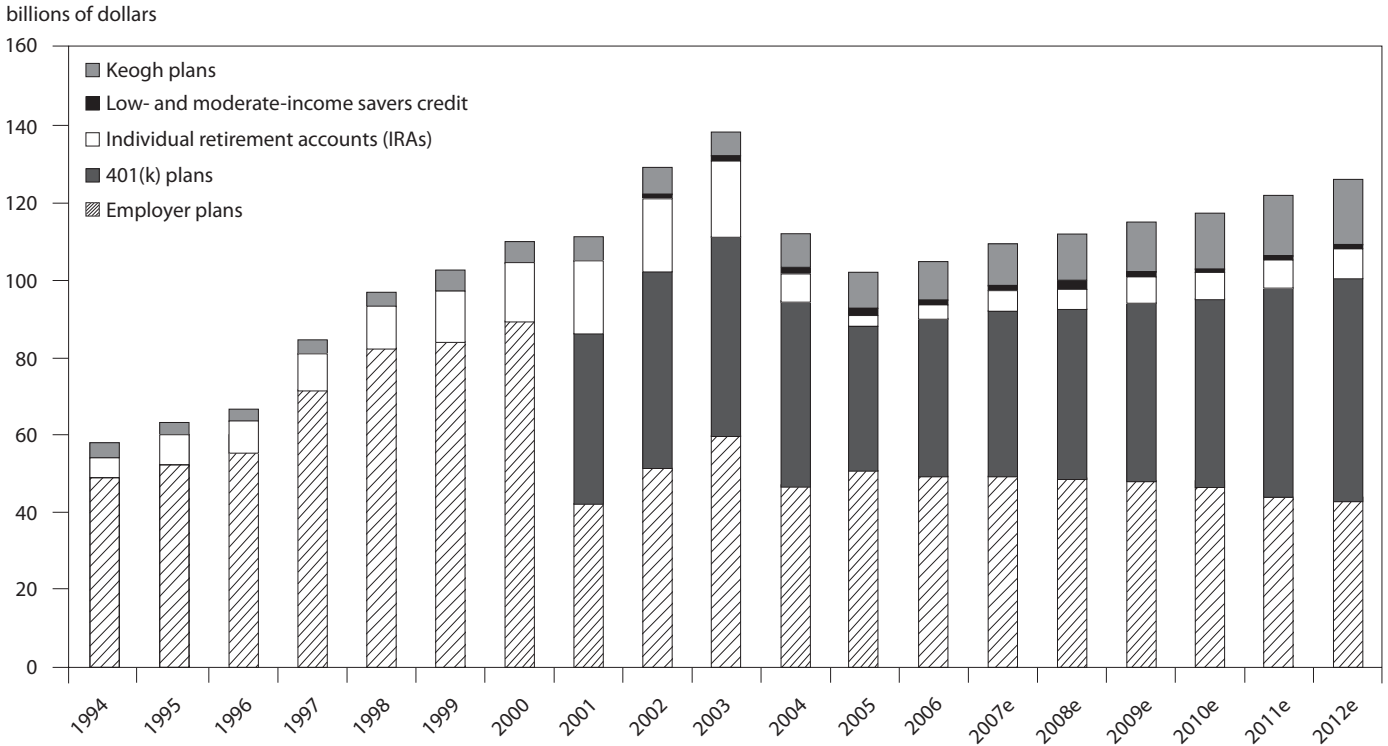
Specifically, we suggest cutting Social Security benefit levels based on a formula that depends upon the degree to which individuals have already taken advantage of public tax expenditures to augment their private pension saving accounts. We are aware that our proposal runs counter to the US penchant of "conducting social policy via tax breaks," but we believe it is worth it in order to financially safeguard the most important direct public benefit program in America. In essence, we are proposing that well-off individuals—who, partly through the use of government-subsidized tax breaks, have achieved a financially secure retirement—rely less on Social Security.

As we noted in chapter 2, aggregate federal government tax expenditures (i.e., the fiscal cost of granting tax breaks for private pension savings) are substantial, amounting to more than $100 billion a year (and rising), largely for employer-sponsored and 401(k)-type plans (figure 8.1).[2] And the numbers understate the amount because they do not include deferred compensation and stock options. We note as a comparative number that the total federal disbursement in redistributive SSI benefits in 2007 was $39.5 billion (SSA 2008, table IV, C1), significantly less than half of the value of tax breaks that year.

Given the US tax structure, it is not surprising that this country has a larger stock of private pension wealth than almost any other OECD country,

2. Some tax breaks granted to corporations may benefit not only individual taxpayers but also shareholders, employees, customers, or other providers of capital, depending on precise economic forces. See OMB (2008, 286). It is important to note that the value (cost to the government) of a tax break rises with the marginal tax rate, hence the decline in federal tax expenditures following the passage of EGTERRA in FY2004, seen in figure 8.1.

Figure 8.1 US federal tax expenditures toward pensions, by category, 1994–2012e



e = estimate

Source: Office of Management and Budget (2008).

at more than 130 percent of GDP. At the same time, we know from chapter 3 that a large group of Americans has no private retirement savings at all, indicating a distributional concern with US retirement savings. A small number of well-to-do Americans will enjoy substantial retirement savings, while a much larger number will have access to only very limited, if any, private savings. Furthermore, as we found in chapter 7, while average US corporate pensions are relatively modest and increasingly in the defined contribution format, they are nonetheless financially reasonably secure and will continue to provide predominantly better-off Americans with additional retirement income.

To a degree, policy is designed to encourage people to do the right thing and set aside enough for their retirement needs. One can argue that those who fail to make such provisions have to expect the consequences of their actions. However, it is a pertinent policy question to ask whether spending $100 billion to $120 billion a year in federal tax expenditures to promote retirement saving is money being allocated correctly, given that it goes overwhelmingly to higher-income groups and that, as we saw in chapter 3, more than a third of Americans have no retirement savings at all and, of those that do, more than a third have less than $10,000.

The results in chapter 3 also showed that only Americans in the top income quintile derive any sizable share of their retirement income from private capital, whereas the overwhelming majority relies almost exclusively on Social Security. Estimating the precise distributional impact of US tax expenditures toward retirement saving is difficult,[3] but updated data from the Congressional Budget Office (CBO 2007) *Utilization of Tax Incentives for Retirement* series provide a glimpse of the situation in 1997–2003.[4]

Table 8.1 shows the rate of participation in tax-favored retirement plans by income group. The share of Americans that save for retirement by participating in tax-favored retirement plans is about 20 percent for those earning less than $20,000 a year, about 50 percent for those earning $20,000 to $40,000, and 70 to 80 percent for income groups over $40,000. As expected, therefore, higher-income groups are overrepresented among participants in tax-favored retirement plans—in progressive tax systems (as in the United States), the benefit of any tax break is greater for higher-income individuals whose tax rate is higher.

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3. Orszag and Orszag (2000) cite US Treasury data that, as of 2000 (when the maximum IRA contribution was $2,000), nearly two-thirds of tax expenditures toward pension and IRA savings accrue to households in the top fifth of the income scale, while the bottom 60 percent receive only 12 percent of these expenditures. They also note that 70 percent of any new expenditures from a proposed reform to raise the maximum contribution amount to $5,000 would benefit the top fifth of income earners, with only 5.5 percent going to the bottom 60 percent.

4. CBO (2007) presents tabulations of a sample of 1997, 2000, and 2003 individual income tax returns and tax information returns.

Table 8.1 Worker participation in tax-favored retirement plans, by income group, 1997, 2000, and 2003

Annual income (1997 dollars)	Total number of workers	Share of total (percent)	Percent actively participating in any retirement plan	Number of workers contributing	Share of total contributing workers (percent)	Cumulative share of contributing workers (percent)
				1997		
Under 20,000	45,686	34	21	9,594	14	14
20,000–40,000	32,066	24	55	17,636	26	40
40,000–80,000	36,720	28	70	25,704	38	78
80,000–120,000	11,474	9	79	9,064	13	91
120,000–160,000	3,491	3	81	2,828	4	95
Over 160,000	3,960	3	77	3,049	4	100
Total	133,397	100	51	68,032	100	
				2000		
Under 20,000	44,660	33	20	8,932	13	13
20,000–40,000	31,932	23	51	16,285	24	37
40,000–80,000	37,013	27	67	24,799	36	73
80,000–120,000	13,036	10	79	10,298	15	89
120,000–160,000	4,352	3	83	3,612	5	94
Over 160,000	5,191	4	79	4,101	6	100
Total	136,184	100	50	68,092	100	
				2003		
Under 20,000	47,515	34	20	9,503	13	13
20,000–40,000	33,410	24	52	17,373	25	38
40,000–80,000	37,428	27	68	25,451	36	74
80,000–120,000	13,281	9	80	10,625	15	89
120,000–160,000	4,562	3	82	3,741	5	95
Over 160,000	4,612	3	79	3,643	5	100
Total	140,808	100	50	70,404	100	

Note: Participation consists of contributing to an individual retirement account (IRA), self-employed plan, or 401(k)-type plan or being enrolled in a noncontributory plan during the given year. The inclusion of the latter group of noncontributory plan participants is, strictly speaking, irrelevant here and preferably would be avoided. Unfortunately, CBO (2007) does not present data of this kind. It does present data, however, showing that participation in noncontributory plans is relatively stable across income groups, with only a slightly higher participation rate for income categories $20,000–$40,000 and $40,000–$80,000 (CBO 2007, table 2). Hence the inclusion of noncontributory plan participants in these data should not affect the income-based conclusions. The income classifier is adjusted gross income plus excluded contributions to retirement plans less taxable distributions from IRAs.

Source: CBO (2007).

Table 8.1 actually understates the participatory bias in favor of higher-income groups by not considering the magnitude of the participation across income groups. Higher-income groups shelter far larger amounts in tax-favored retirement plans than do lower-income groups, as is evident in the share of each income group that contributes the maximum amount allowed to their tax-favored retirement savings plan.

In 2003, after the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTERRA), those with 401(k)-type retirement plans could contribute a total of $12,000 ($14,000 for those over age 50); before passage of the Act, the limit was $11,500 for all participants or a maximum of 25 percent of income (EGTERRA abolished the percentage of income limitation). Also before EGTERRA, participants in IRAs could contribute up to $2,000, an amount that rose to $3,000 with EGTERRA ($3,500 for those over age 50).[5] Table 8.2 shows the share of 401(k)-type and IRA plan participants by income groups that contributed these maximum amounts. Not surprisingly, hardly any low-income participants contributed the maximum, whereas a substantial share of the top income group(s) did. The relatively modest $500 increase (i.e., less than 5 percent) of the maximum contribution level with EGTERRA for 401(k)-type plans significantly lowered the share of maximum contributors.

The data in table 8.2 also indicate that many people do not act entirely rationally when making their retirement saving decisions. Rational decision makers would always attempt to shelter as much of their earnings as affordable in tax-favored retirement plans, and it seems implausible that a significant share of Americans earning over $160,000 (in 1997 dollars) could not afford an extra $500 to reach the new $12,000 contribution ceiling with EGTERRA. Instead, it seems likely that well-off 401(k) investors simply went with the status quo of $11,500.[6] Yet for IRA participants, the increase in maximum contributions from $2,000 to $3,000 meant that only about half as many low-income participants contributed the maximum amount and had very little impact on high-income participants.

Table 8.3 presents data from CBO (2007) for 401(k)-type, IRA, and self-employed retirement plans, and as can be seen, a rising share of total tax-sheltered retirement savings in these three savings vehicles comes from the top income groups. In 1997, 27 percent (about $32.5 billion) of total tax-favored retirement savings came from people with income over

5. Data from CBO (2007). These thresholds for maximum savings adjust upwards each year to reflect higher incomes and inflation. In 2007 the maximum contribution in a 401(k)-type plan was $15,500, with an additional $5,000 "catch-up" provision for those over age 50. For IRAs, the 2007 limit is $4,000 ($5,000 for those over age 50).

6. See Kahneman and Tversky (1984) for a description of this "status quo bias."

Table 8.2 Percentage of participants contributing the maximum to tax-favored retirement plans, by plan type and income group, 2003

	401(k)-type plans		Individual retirement accounts	
Annual income in dollars	Pre-EGTERRA	Post-EGTERRA	Pre-EGTERRA	Post-EGTERRA
Under 20,000	1	<1	50	28
20,000–40,000	1	<1	56	33
40,000–80,000	4	1	71	55
80,000–120,000	12	6	81	71
120,000–160,000	26	16	95	87
Over 160,000	52	37	97	87
Total	9	5	71	55

EGTERRA = Economic Growth and Tax Relief Reconciliation Act of 2001

Source: CBO (2007).

$120,000, or essentially the top 5 percent of households that year.[7] This share rose to 31 percent (about $47.6 billion) in 2000 and 32 percent (approximately $60 billion) in 2003. Combining table 8.1 with table 8.3, the top 5 to 6 percent of US workers in 2003 accounted for approximately a third of all tax-favored retirement savings. And this group not only benefits from government-subsidized tax-benefited savings but also receives well-above-average Social Security benefits in retirement. This is, therefore, the group we envision will be most affected by our reform proposal, which calls for reallocating some of the savings subsidies given to this (or a broader definition of) top-income group—say those making over $100,000 a year—of US tax-favored retirement savers and essentially using the savings to shore up the Social Security program.

This group can reasonably be said to be having its cake and eating it too by receiving well-above-average Social Security benefits in retirement as well as benefitting personally from government-subsidized tax-benefited savings. It is important to consider this proposal in the context of the overall tax system. First, the limits on the amount of money that can be set aside in tax-advantaged savings have risen significantly in recent years. Second, tax-advantaged health insurance, tax-advantaged mortgage interest, tax-advantaged retirement saving, and the tax treatment of capital gains all

7. In 1997, according to the Census Bureau's income limits, the threshold for inclusion in the top 5 percent of US households by income was $126,500 in current dollars. The CBO (2007) income groups are based on real 1997 income groups (i.e., in 2003, you had to make over $160,000, in 1997 dollars, to be included in the top group), that comparisons of current dollar thresholds across years are difficult.

Table 8.3 Employee contributions to 401(k)-type, IRAs, and self-employed retirement plans, by income group, 1997, 2000, and 2003

Annual income in current dollars	1997			2000			2003		
	Number of participants (thousands)	**Average contribution** (1997 dollars)	**Total contribution** (billions of 1997 dollars)	**Number of participants** (thousands)	**Average contribution** (2000 dollars)	**Total contribution** (billions of 2000 dollars)	**Number of participants** (thousands)	**Average contribution** (2003 dollars)	**Total contribution** (billions of 2003 dollars)
	401(k)-type plans								
Under 20,000	2,448	546	1.3	2,611	680	1.8	2,976	726	2.2
20,000–40,000	8,331	1,324	11.0	8,248	1,498	12.4	8,806	1,583	13.9
40,000–80,000	14,718	2,482	36.5	15,112	2,822	42.6	15,753	3,162	49.8
80,000–120,000	6,310	4,131	26.1	7,019	4,549	31.9	7,511	5,287	39.7
120,000–160,000	1,958	5,360	10.5	2,561	6,116	15.7	2,741	7,476	20.5
Over 160,000	1,902	7,054	13.4	2,675	7,522	20.1	2,470	9,503	23.5
Total	35,666	2,772	98.9	38,226	3,257	124.5	40,257	3,716	149.6
	Individual retirement accounts (IRAs)								
Under 20,000	925	1,428	1.3	1,197	1,352	1.6	1,156	1,689	2.0
20,000–40,000	2,062	1,513	3.1	2,236	1,497	3.3	2,160	1,962	4.2
40,000–80,000	2,631	1,520	4.0	3,736	1,593	6.0	3,688	2,181	8.0
80,000–120,000	1,012	1,741	1.8	2,055	1,744	3.6	1,810	2,444	4.4
120,000–160,000	517	1,863	1.0	911	1,771	1.6	690	2,635	1.8
Over 160,000	670	1,915	1.3	727	1,879	1.4	540	2,941	1.6
Total	7,818	1,593	12.5	10,860	1,620	17.6	10,045	2,197	22.1
	Self-employed retirement plans								
Under 20,000	32	2,245	0.1	39	2,057	0.1	35	3,099	0.1
20,000–40,000	93	2,665	0.2	98	2,959	0.3	97	4,021	0.4
40,000–80,000	269	4,098	1.1	319	4,316	1.4	260	6,314	1.6
80,000–120,000	242	6,360	1.5	268	5,821	1.6	268	8,940	2.4
120,000–160,000	145	9,433	1.4	156	9,110	1.4	170	13,315	2.3
Over 160,000	340	14,578	5.0	453	16,058	7.3	443	23,977	10.6
Total	1,159	8,115	9.4	1,332	9,007	12.0	1,274	13,685	17.4

(table continues next page)

Table 8.3 Employee contributions to 401(k)-type, IRAs, and self-employed retirement plans, by income group, 1997, 2000, and 2003 *(continued)*

	Total contributions to 401(k)-type, IRAs, and self-employed retirement plans					
Annual income in current dollars	**Percent share of total**	**Total contribution** (billions of 1997 dollars)	**Percent share of total**	**Total contribution** (billions of 2000 dollars)	**Percent share of total**	**Total contribution** (billions of 2003 dollars)
Under 20,000	2	2.7	2	3.5	2	4.2
20,000–40,000	12	14.4	10	16.0	10	18.6
40,000–80,000	34	41.6	32	50.0	31	59.5
80,000–120,000	24	29.4	24	37.1	25	46.5
120,000–160,000	11	12.8	12	18.7	13	24.6
Over 160,000	16	19.7	19	28.8	19	35.7
Total	100	120.7	100	154.1	100	189.1

Source: CBO (2007).

combine to skew policy such that the largest tax benefits go to the upper-income cohorts, thereby reducing the overall progressivity of the tax system.

Impacts of Pension Integration on Saving Incentives

Integration of the public and private pension benefit systems previously meant the proportional adjustment of private pension benefits to the level of benefits from Social Security. We propose instead an Internal Revenue Service (IRS)/Social Security Administration (SSA) linking mechanism that would reduce the level of Social Security benefits only for those with tax-favored retirement savings (i.e., those who have already benefited from public financial support through their use of federal tax breaks). We believe this selective approach is intuitively fairer (and thus ought to be politically more palatable) than other approaches to targeted Social Security benefit cuts.

One immediate concern with this proposal is that it would reduce the return to private pension saving. Even economists who strongly support the Social Security system have voiced this concern to us, especially given that the United States has such a low saving rate. Do we really want to reduce saving incentives? We offer several observations to allay this concern.

First, we note that we are also supporting the introduction of individual accounts as an add-on to Social Security and that such a program has the potential to increase national saving in a way that benefits lower-income workers. We are aware of the need for a higher saving rate in the United States, but we judge that this should come through a broader-based incentive for saving rather than through a narrow program (together with a plan to balance the federal budget).

Second, the provisions for tax-preferred private saving have become much more generous in recent years. We do not propose eliminating all tax advantages for saving, nor reducing Social Security benefits dollar for dollar based on the extent of the tax preference in any pension saving. Rather, we would scale back the tax advantages, making them comparable to the level of, say, ten years ago (after adjusting for inflation).

Third, the impact of savings tax subsidies on the level of saving is generally small. A tax advantage that increases the rate of return on saving will have offsetting effects on the amount of saving. To illustrate, consider the positive incentive for saving: If I decide to reduce my consumption today and set aside $1,000 for retirement, in 20 years it will yield $1,800 at a 3 percent real rate of return. If, instead, the rate of return is increased to 6 percent because of tax advantages, then the $1,000 will become $3,200 after 20 years, a large difference that will encourage me to save that $1,000 rather than spending it now. With the tax incentive, savers get more for any given dollar level of saving. Thus an increase in the return to saving has a substitution effect that may cause individuals to consume less today and set aside more for tomorrow.

The same tax break, however, creates an incentive for saving less because it makes it easier to reach any given retirement target. For example, if I decide that I need to have $1 million set aside when I retire, a higher rate of return makes it easier for me to reach that goal and I can actually save less. For example, at a 3 percent rate of return, I need to save $3,046 a month for 20 years in order to end up with $1 million, whereas at a 6 percent rate of return I need to save only $2,164 a month. This is the income or wealth effect of a higher rate of return, and it can work to reduce saving.[8]

In practice, the incentives for more and less saving operate at the same time and we would like to know which effect will predominate. That is an empirical question and economists do not agree on what the data show, but generally the answer is that the two effects offset each other, and the net impact of an increase in the rate of return is pretty small either way.

Pension savings tax breaks may have very little positive effect on saving, or even a net negative effect, because for any individual or family that is saving the maximum amount under the tax-advantaged program, there is only the income effect and not the substitution effect. In table 8.2 we saw that a substantial percentage of families with incomes over $160,000 were at the maximum contribution, so we look at an example of this type. Suppose that there are no tax-advantaged saving plans for a very affluent family saving $6,250 a month, or $75,000 a year. They invest at a 3 percent real return and after 20 years with the same annual saving level, they have accumulated a nice retirement nest egg of $2.05 million. Now suppose the government gives them a tax advantage on the first $50,000 a year of their saving ($4,167 a month), so that this level of saving now earns 6 percent a year. This tax-preferred retirement account will accumulate to $1.93 million after 20 years, leaving them nearly as well off as they were before. The first $4,167 per month of their saving ($50,000 a year) will yield a retirement nest egg that is roughly equal to the one they reached by saving $6,250 a month before the tax break. So how much does the family decide to save now that they have the tax break—more or less? If they save more than $50,000 a year, they will earn the lower rate of return on their savings and so the chances are pretty good that they will choose to save less than the $75,000 a year they were setting aside before the tax break.[9] They do not need to save as much (the income effect), and there is no subsidy to their marginal or additional dollars of saving.

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8. Exactly how rational saving choices change with changes in income depends on the specific attributes of individual preference functions. A general increase in income (a salary increase, for example) is likely to increase both consumption and saving—splitting the extra money. So it is hard to be certain just from theory how people will be affected by policy changes.

9. Rational saving decisions are made on the basis of maximizing welfare over entire lifetimes. When the rate of return rises, people are better off and choose to consume more, including during their retirement years. The saving decisions made over the entire lifespan may be affected either way.

Moreover, because the tax break will also reduce the government's tax revenue, unless there is an increase in other taxes or a decrease in government spending, it is almost certain that it will reduce total national saving.[10]

Is this a realistic example? We have exaggerated the effects a bit to make the case—current tax breaks do not result in a doubling of the rate of return, especially since participants have to pay tax on the withdrawals in retirement[11]; and only a fraction of the population saves the maximum amount allowed to qualify for tax-preferred treatment. But the point is correct and important. When affluent families file their tax returns, their accountants tell them how much they can put into tax-preferred accounts and they move that money from another account in order to reduce their taxes for the year. They do not save an additional amount. The very affluent are a small fraction of the population, but they account for a large fraction of total saving.

Finally, we note again that saving behavior does not always follow the rules of rational economics. Indeed, that is why programs like Social Security require people to contribute to a pension program. An extensive literature of behavioral finance has documented the fact that people are often irrational when making decisions concerning their saving.[12] (These behavioral findings already inform the design of private pension schemes [Benartzi and Thaler 2004]; we attempt to partly introduce them to public pension schemes.) Setting an optimal saving rate is a difficult decision involving an intertemporal choice under a great deal of uncertainty about future income and future rates of return on different assets. As a result, people do not evaluate their future needs but instead make a series of short-term decisions.

Would our proposal to help Social Security cause people to reduce the amount they were setting aside in tax-preferred saving accounts? People would be making a choice between, on the one hand, paying more taxes today and preserving some unknown distant future level of Social Security benefit, and, on the other hand, paying less tax today, knowing that it is still a worthwhile investment overall. This choice is affected by two concepts in behavioral finance, "hyperbolic discounting" and "loss aversion." George Loewenstein and Richard Thaler (1989) describe the notion of hyperbolic discounting, in which people attach too little importance to

10. See Engen, Gale, and Scholz (1994) for a more in-depth discussion of the ambivalent effects of savings tax incentives on national savings.

11. Although this is offset with provisions that allow families to pass wealth on to their children and further postpone the taxes.

12. See, for instance, Kahneman and Tversky (1984), Loewenstein and Thaler (1989), Kahneman, Knetsch, and Thaler (1991), Madrian and Shea (2000), Choi et al. (2003, 2005), and Beshears et al. (2006, 2007).

the distant future compared to what would be predicted from a rational evaluation.[13] They give more weight to the immediate benefit of the tax break than to the future loss of benefits, even if the two are equal in present value. They are, therefore, less likely to change their retirement savings in tax-sheltered plans than would be rationally predicted.

Daniel Kahneman, Jack Knetsch, and Richard Thaler (1991) illustrated that people who suffer from "loss aversion" are disproportionally—at a ratio of perhaps 2:1—averse to suffering a loss (relative to their perception of an equal gain). This is important in relation to our proposal, as Daniel Feenberg and Jonathan Skinner (1989) find that one of the most important predictors for whether individuals put money into an IRA is whether they would otherwise have to write a check to the IRS on April 15: Those who owe the IRS money are far more likely to buy an IRA than those getting a refund.[14] Lawrence Summers (1986) further showed that most IRA purchases are made at the last minute, contrary to what a rational person would do, which is to secure tax-sheltered status at the earliest possible date.[15] Thaler (1994) cites this behavior as an example of loss aversion, as would-be savers resist writing a check (i.e., suffering a loss) to the IRS and instead invest the money in an IRA. A similar (lack of) logic will likely cause Americans to take advantage of the tax breaks for retirement saving today despite their awareness of the associated future cuts in their Social Security benefit entitlements. As with hyperbolic discounting, we believe that this will limit any adverse impact of our proposal on the overall level of present savings.

How Much Money Is on the Table?

We saw above that the federal government spends about $120 billion (and rising) annually in tax expenditures for retirement savings, and we have explained why we do not expect our proposal to affect this level of tax expenditure. In other words, this is not the channel through which we intend to cut costs.

We also illustrated that high-income Americans derive most of the economic benefits of tax-benefited retirement plans. We, therefore, propose to cut future Social Security benefits through some proportional formula for Americans earning over $100,000 a year who take advantage of

13. Hyperbolic discounting in mathematical terms implies that the discount function is a generalized hyperbola; events τ periods away are discounted with factor $(1 + \alpha\tau)^{-\alpha\delta}$, with α, $\delta > 0$. Such discount functions imply a monotonously falling discount rate. Hereby the near future is discounted too deeply, as too much importance is attached to it.

14. Thaler (1990, 200) describes this as the "I would rather put $2,000 [the 1990 maximum for IRA contributions] in an IRA than pay the government $800" approach to pension saving.

15. See also Akerlof (1991) for a description of self-control and procrastination problems.

tax breaks for their retirement saving. We have chosen the $100,000 threshold because it is a round number, and in 2006 it designated the top income quintile in America.[16] As such, we feel this threshold ensures that we intuitively affect only "high-income Americans" with our proposal. Given that we lack access to linked longitudinal micro-level data for both IRS tax receipts (i.e., data on the degree to which high-income individuals claim tax breaks) and the same individuals' Social Security benefit entitlements later in life, we cannot say with any precision just how much money our reform might save the SSA.

No data are available from the SSA indicating the total dollar figure for benefit payments to Americans who earned more than $100,000 in 2006.[17] However, a look at data for the sources of income for Americans over 65 by income quintile yields some clues. In chapter 3 we saw that only Americans in the top income quintile did *not* derive the majority of their old age income from Social Security benefits. For this top group, Social Security benefits made up only 22 percent of total income. Thus in our proposal we are talking about cutting only a minor source of old age income for high-income Americans.

The Employee Benefit Research Institute (EBRI) publishes an annual dataset for old age income sources by income quintile based on the same Current Population Survey (CPS) data we used in chapter 3.[18] These data allow us to give an approximate dollar figure for the amount of Social Security benefits going to Americans in the top income quintile.[19] However, here we are talking about the top income quintile over age 65, whereas before, when concerned about which Americans took advantage of tax-benefited retirement plans (the $100,000 threshold), we were referring to all ages of the top income quintile. The lack of linked longitudinal micro-level data creates a methodological discrepancy; however, we are fairly certain that the groups will overlap through time, meaning that if you belong to the top income quintile during your working life, you will remain in that group in retirement.

Figure 8.2 shows that the share of Social Security benefit disbursements to the top income quintile has been relatively stable at approximately 25 percent. In 2006 the threshold for inclusion in the top income quintile for those over 65 was $34,570, and this group, on average, had a total income of $70,176.

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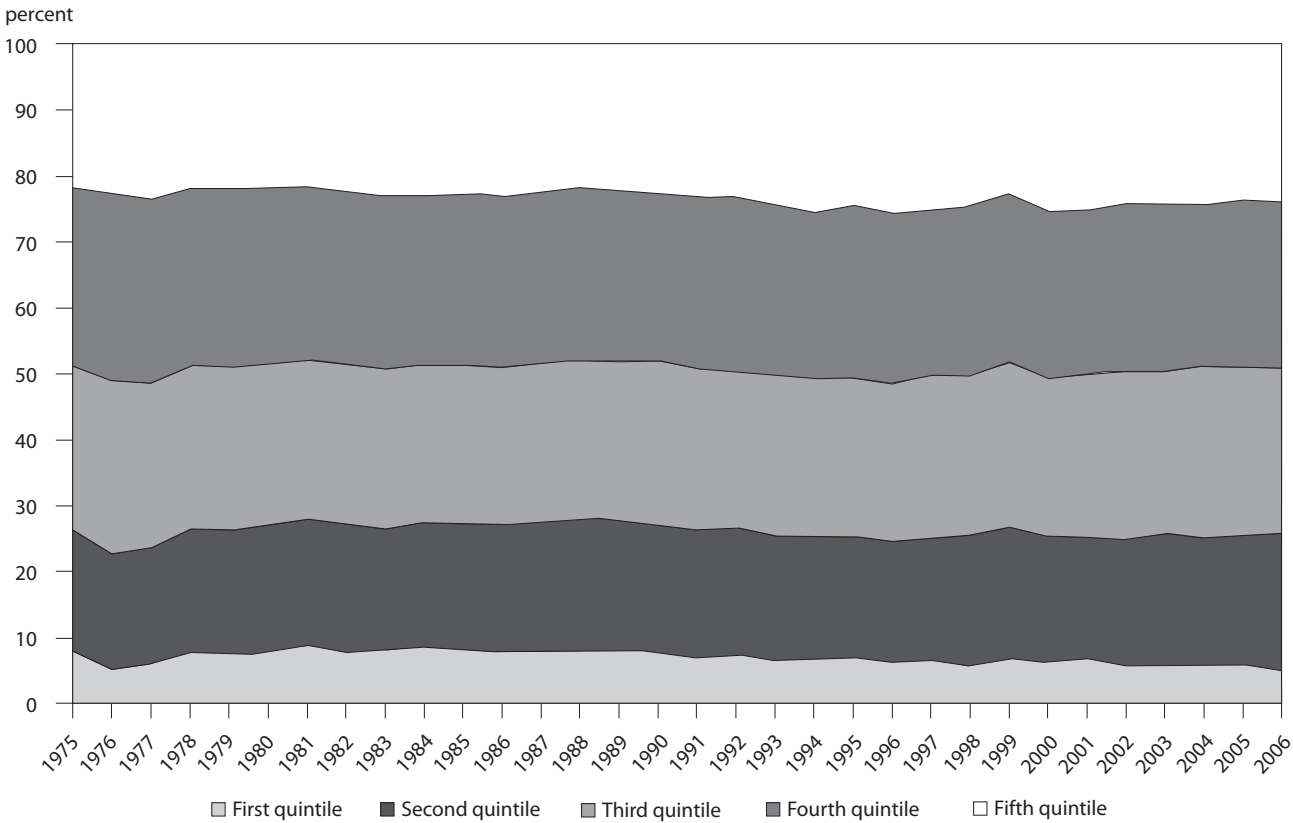
16. The Census Bureau's Income Table H-1 indicates that the lower limit for inclusion in the top income quintile in America in 2006 was $97,033, available at www.census.gov.

17. Data are available for benefit payments only by benefit category, not income group. See the SSA website at www.ssa.gov.

18. See table 7.5 in the EBRI databook, available at www.ebri.org.

19. Some methodological concerns surround the use of CPS income data. See Weinberg (2006) for a detailed discussion of the validity of CPS income data.

Figure 8.2 Share of total Social Security benefit income of individuals age 65 and over, by recipient income quintile, 1975–2006



Source: Employee Benefit Research Institute.

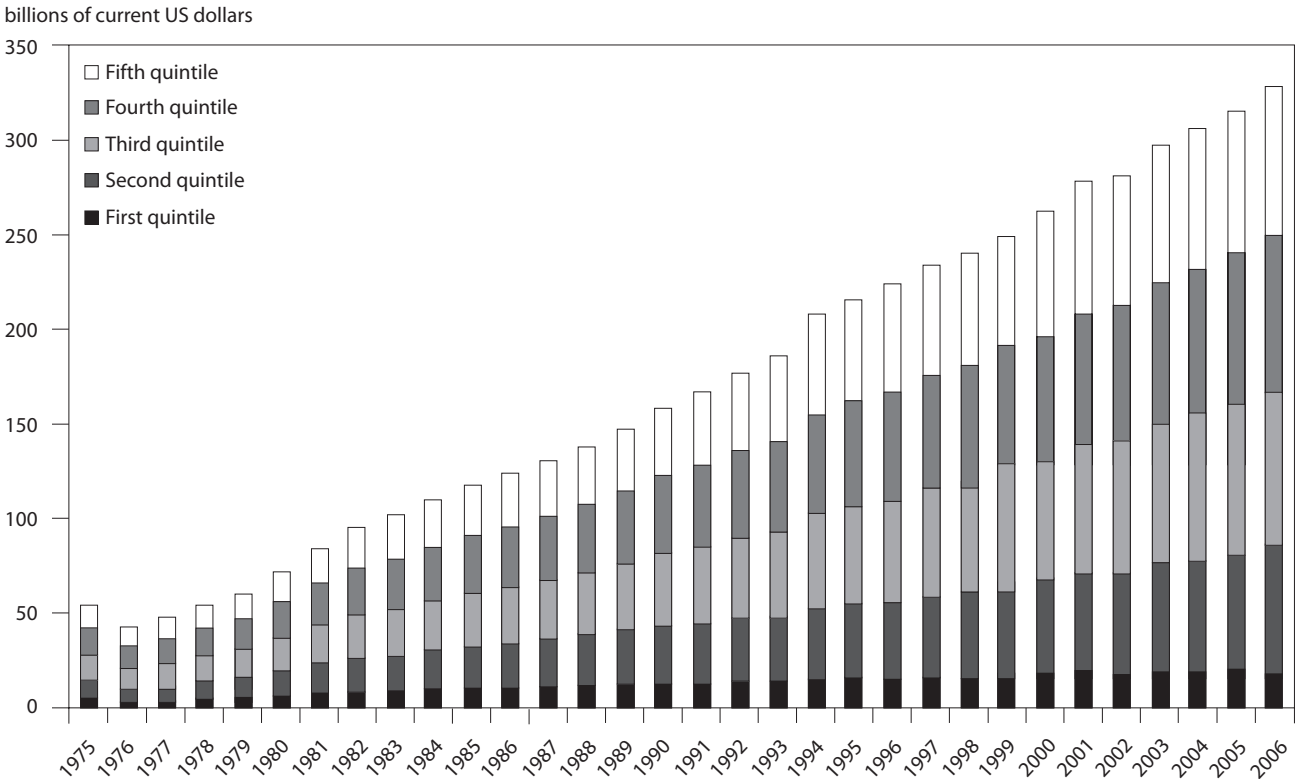
The same EBRI data allow us to calculate a rough estimate of the dollar figure for Social Security benefit income for each income quintile. Figure 8.3 illustrates the rising trend in total Social Security benefit payments each year, as more and more Americans retire and begin withdrawing benefits. By 2006 the level of Social Security benefits to the top income quintile had risen to more than $78 billion. These data are derived from CPS income data for Americans age 65 and over, so totals do not necessarily correspond with the data for total SSA disbursements. In 2006, total Old Age and Survivors Insurance (OASI) expenditures were $460 billion, of which $367 billion went to retired workers and dependents, while the remaining almost $100 billion benefited survivors (mostly aged and disabled widowers).[20] This compares with the $320 billion in total recipient income in 2006 indicated in figure 8.3. This difference likely results mostly from OASI expenditures for early retirement benefits for Americans aged 62–65 and benefits to dependents not included in the CPS income data for Americans aged 65 and above. As such, the $78 billion estimate of Social Security benefits to the top income quintile aged 65 years and older is likely biased downward.

How much money would our proposal shift? We do not have the data to spell out the details, so we will only estimate the amount. Given the $120 billion in annual tax expenditures toward retirement saving and at least $80 billion in Social Security benefits to recipients 62 and older in the top income quintile (who benefit the most from tax-favored retirement plans), we believe that a reasonable estimate is that about $30 billion to $40 billion in annual benefit reductions is possible by targeting those who take advantage of tax-preferred pensions. Thus our pension integration proposal would save about 50 percent of the Social Security benefits paid to recipients in the top income quintile.

Through this proposal, we would move the Social Security system away from the German insurance model and toward an income support program. But given the relatively regressive character of the large federal tax expenditures for retirement saving, in our view this is a sound policy. As part of our comprehensive approach to reforming Social Security by looking across a variety of challenges, one might say that we intend to make Social Security itself more progressive, but in reality we believe we would merely be making the entire US old age income security system (i.e. considering the large role of private savings and corporate pensions, too) and the role of the federal government herein less regressive. Moreover, our cross-country evidence concerning the relative progressiveness of OECD public retirement systems (chapter 3) suggests that there is no reason to believe that making US Social Security more progressive will undermine broad political support for the system. There has been no loss

20. SSA data, available at www.ssa.gov/oact/stats.

Figure 8.3 Social Security benefit income of individuals age 65 and over, by recipient income quintile, 1975–2006



Source: Employee Benefit Research Institute.

of such support in OECD countries with far more progressive public retirement systems, nor was there in the early decades of the US Social Security system, when, as we saw in chapter 3, the system was far more progressive than today.

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

Adjusting the Retirement Age

There is no economic principle for determining the optimal retirement age or age range for a public retirement program like Social Security. The medical profession tells us that, on average, there is deterioration of physical and mental capacity—vision, hearing, mobility, and memory—with age. But there are tremendous individual variations, with some 80-year-olds able to run marathons that many 30-year-olds cannot. Scientists are said to peak in their 30s, and yet Galileo accomplished some of his finest scientific achievements studying the laws of motion when he was well over 60.[21]

This variation across individuals suggests that differing preferences and circumstances lead to very different choices, and so perhaps the retirement decision should be left to the individual. Social Security does build in some flexibility, allowing people to choose to retire as early as age 62 or to postpone receiving benefits until as late as age 70 in order to receive a higher benefit level. And in recognition that many people remain active and sharp as they age, the United States has abolished most mandatory retirement provisions for companies. Currently, the increases in the "normal" retirement age have not been accompanied by increases in the minimum retirement age to be eligible for Social Security benefits. That creates the danger that some people will retire at 62 without realizing that their monthly benefit level will not suffice to support them as the years pass, especially as their health costs rise. To avoid this problem, it would be better to gradually increase the minimum age for Social Security benefits as well, indeed to let the whole range of retirement ages rise.[22]

We have learned from our cross-country analysis that the age of retirement has a huge impact on the retirement pension budget. While expected lifespan has increased in all OECD countries, the age of retirement

21. His book *Dialogues Concerning Two New Sciences* was published in 1638 in Leyden when Galileo was 74. It was "his most rigorous mathematical work, which treated problems on impetus, moments, and centers of gravity," according to a biography by St. Andrews University, available at www-history.mcs.st-andrews.ac.uk.

22. See also Barr (2006) for this issue.

has declined since 1970, and the combination of these two effects has sharply increased the number of years spent in retirement and put tremendous strain on pension budgets. The United States is relatively well off despite these developments because it has not reduced the age at which benefits can be received; indeed it is gradually raising the normal retirement age from 65 to 67 by 2027. But there will be no further increases in retirement age after that unless there is a change in the law.

The SSA has prepared estimates for several types of life expectancy linkages, similar to what we propose, which, as we have found in other OECD countries, illustrate that this is a very powerful policy tool for long-term pension system sustainability. For instance, indexing the Social Security normal retirement age after 2027 to changes in longevity would reduce the long-term actuarial deficit by 0.37 percent of taxable payrolls[23] or, when compared with the new CBO estimates cited at the beginning of this chapter, about one-third of the total necessary adjustment to achieve long-term Social Security sustainability.

We propose to link the range of eligibility ages for Social Security benefits to changes in life expectancies after 2027 in a way that keeps constant the ratio between years spent in retirement and the rest of an individual's lifetime (the "expected time in retirement" to "total life time not in retirement," or ETR-TNR, ratio described in chapter 3). This would mean that the earliest age (now 62) of eligibility would also rise with life expectancy.[24] Such an indexing could occur automatically based on the best available estimates of life expectancy.

However, the Social Security program is based on the idea that people may need guidance in their retirement decisions, so it is important that any public debate on Social Security reform be based on a realistic view of the tradeoffs involved. If participants want to increase the number of years during which they receive benefits, they must expect to contribute more, either by making higher contributions or by working for more years. While economic theory does not provide a definitive answer to which of these choices people would make if they acted rationally, it does suggest pretty strongly that increases in expected lifespan should

23. See SSA Long-term Solvency Provision, C-7, available at www.ssa.gov. This scenario increases the normal retirement age by one month every other year. Another SSA scenario (C-6) suggests that a constant ratio of expected retirement years to potential work years would yield savings of similar magnitude.

24. It is important to note, however, that we do not foresee many future savings to the OASDI Trust Fund from linking the earliest age of eligibility (62) to life expectancy. This is due to the fact, discussed in chapter 3, that many people in the age group of 62 and up who retire early would likely instead seek and receive disability benefits. The SSA thus estimates that the total savings to the OASDI Trust Fund from raising the earliest age of eligibility from 62 to 65 would lead to an improvement in the Trust Fund's long-term balance of only 0.01 percent of payrolls. See SSA Long-term Solvency Provision, C-8, available at www.ssa.gov.

be met in part by increases in the number of years at work. We, therefore, believe that the rule of thumb should say that the retirement age should be increased in response to expected lifespan increases in such a way that the proportion of life spent in retirement remains constant. If Social Security participants, through their representatives, decided that the expectation of extended working years imposed too great a burden on the elderly, then the rule could be changed, provided tax contributions were adjusted to sustain solvency. Individuals would retain the right to choose their retirement age from within a range, as in the current system.

Increasing Revenues for the Social Security System

As discussed in chapter 1, we do not believe that an internationally comparative methodology, such as the one used in this book, can provide us with the insights into how to potentially raise additional revenues in the future for the Social Security system. The differences between individual countries' revenue-raising laws and traditions are simply too great. As such, we do not feel we are in a position as part of this project to provide any guidance as to the specifics of the design of any new revenue-raising measures for Social Security. However, we do believe that any additional revenue needed to "fix Social Security for the long term" should be raised as a "plug" to fill any additional long-term financial shortfall left over from the implementation of our first two proposals to remedy the current Social Security financial imbalance.

Our proposals will appropriately distribute the "reform pain" over as broad a range of groups as we deem possible. We are confident that the need for additional revenues for Social Security would be relatively modest after the implementation of our reform proposals concerning tax breaks and retirement ages, especially in comparison to the need for increased revenues to finance projected levels of accelerating Medicare and Medicaid costs as well as continuously rising levels of discretionary spending. In this context, any additional revenue-raising measures needed to balance Social Security's finances in perpetuity are undoubtedly among the lesser of the fiscal challenges facing the United States today.

Add-On Program of Individual Accounts

The United States has a market economy and generally allows individuals to make their own spending decisions. On that basis, perhaps people should decide for themselves if they want to set aside part of their disposable income to save for their retirement years. We disagree, however, and

build the case for a government-sponsored program of individual accounts based on three elements.

First, most low- and middle-income households lack the information and training necessary to make good investment decisions. Many people do not know the difference between stocks and bonds, do not know how to pick a mutual fund suitable for retirement, and can, therefore, benefit from guidance on retirement saving. Although employers with sponsored retirement plans frequently provide such guidance, many workers and the self-employed do not have this advantage. Second, low- and middle-income households that start small retirement accounts face management or transaction fees that are large relative to their contributions. This is one of the lessons learned from the experience of other countries. Small savers would benefit if the government pooled funds and covered administrative costs, thereby enhancing the returns earned by small accounts. Third, many households are not able to project their future and decide rationally how much they will need. Even sophisticated and educated individuals have trouble doing this and make rule-of-thumb decisions instead. As explained above, one of the ways people fail to make rational long-term decisions is that they favor current consumption over the future.

Do these points make an economic case for a compulsory saving system for those who do not save enough voluntarily? There is a case for compulsory auto insurance because otherwise, uninsured drivers involved in accidents lack the resources to reimburse the parties they have damaged. Their lack of insurance makes them a burden on others. Similarly, there is a case for compulsory health insurance because otherwise, those who have coverage pay for those who receive treatment without it. Those who lack health insurance are a financial burden on others. Similarly, there is a case for compulsory retirement saving because people who reach old age without having saved enough to support themselves have to be supported by the rest of society. The alternative of allowing the elderly poor to starve or become homeless is a socially unacceptable outcome.

The latter argument was part of the reasoning behind the creation of Social Security and the SSI program in the first place: Americans were unwilling to see the elderly become destitute. So the case for a compulsory add-on individual account system has to be made on the grounds that the programs introduced in the 1930s and expanded since then do not provide adequate incomes to the elderly going forward, especially considering future health care cost increases and likely restrictions on Medicare and Medicaid spending. An alternative approach would be to expand Social Security or the SSI program to provide more support to the elderly. However, a compulsory saving plan would provide distinct advantages in the form of increased national saving and greater transparency—workers would see where their money was going and would be less likely to consider the contributions as taxes.

How would an add-on saving program work? Employers and employees would be required to contribute a percentage of Social Security payroll to the plan with the funds collected by the IRS and turned over to the SSA, just as FICA taxes are collected today (2.5 percent of taxable payroll from employees and employers, for example). Instead of being put in the current trust fund, however, the money would be passed to private fund managers for investment in an age-adjusted standard portfolio, the default choice for all participants. The standard portfolio would consist of US and international stocks and bonds, with the selection made by the investment managers. Those who wanted a different portfolio choice could request it, subject to limits; if participants wanted to choose green funds, for example, they could do so provided there are fund managers willing to create such funds. An independent board of trustees, charged with maximizing returns without regard to other goals, would select and supervise the managers. The government would be prohibited from voting any equities or of influencing the choices of the investment fund managers.

We believe that compulsory add-on savings accounts are justifiable but that, given the popular aversion to taxes and the need for fiscal adjustment, it would not be politically feasible to introduce a compulsory program now. Instead, we propose a voluntary program in which workers are automatically enrolled unless they opt out. Such an approach can encourage enrollment, as evident in recent pension reforms in the United Kingdom and New Zealand, which implemented auto-enrollment features in their national pension schemes.[25] Workers should also receive information about the advantages of the IRS and SSA coverage of the program's administrative costs, enabling market returns with smaller fees than would be available for small individual accounts in the marketplace. Higher-income workers enrolled in employer-sponsored plans would probably choose to opt out. Employers that provided matching funds in a preexisting retirement program would not be required to contribute to a government plan on behalf of their employees.

It may also be possible to create an additional incentive for participation. Although we have argued that there should be increases in the normal retirement age, they would create "leakage" between pension systems: If the age of earliest retirement is also increased (from 62, where it is today), then some workers needing to retire early will retire on disability instead, thus eliminating any revenue savings from the later retirement age. If the age of earliest retirement is not increased but the benefits are actuarially reduced, then some workers will retire early, and then either they or their spouses will be in poverty when they become very old. To address these problems, the rules for early retirement could be adjusted depending

25. See chapters 5 and 6 for discussion of the New Zealand KiwiSaver program and recent UK pension reforms.

on whether or not the worker had participated in the add-on savings plan. Workers who had participated would automatically be eligible to receive benefits at age 62; those who had not would have to demonstrate that they had adequate funds to avoid poverty in retirement, and if not, they would have to start receiving benefits at a later age. This provision would encourage the development of the add-on individual accounts.

Timing the Reform of Social Security and Automatic Balancing Mechanisms

> *Without corrective legislation in the very near future, the Old Age and Survivors Insurance Trust Fund will be unable to make benefit payments on time beginning no later than July 1983.*
>
> —OASDI Trustees (1982, 2)

Based on our cross-country research, we are fairly optimistic about the potential for reforms of the Social Security system, as we believe that solutions are feasible with only a modest amount of pain for both current and future US taxpayers and retirees. Yet the simple stubborn fact is that the problems with Social Security are of a magnitude that require cautious, workable, and farsighted reform, and the feasibility and timeliness of such reform are hindered by political factors. The quotation above indicates that the last reform of Social Security came about only in the nick of time before the exhaustion of the OASI Trust Fund,[26] suggesting that a "crisis" was necessary for reform to be politically possible.[27] Similarly, we have seen that in other OECD countries (and the United States in 1983) there is a tendency to implement pension reforms with a substantial time lag so that any potentially painful alterations affect voters long after the reformers have left office.

Although such delays reflect the political necessity of getting any pension reform passed by the legislature, they also pose potentially significant intergenerational fairness issues. Therefore, we make the case for a prompt reform of Social Security by briefly touching on the timing of pension reforms and reviewing the use of automatic balancing mechanisms (ABMs), a policy tool to eliminate pension reform procrastination among policymakers. Because future policymakers may opt to suspend or

26. Romig (2006) describes how, as part of the 1983 reform, the OASI Trust Fund in November and December 1982 to avoid cash-flow problems had to borrow $17.5 billion from the Disability Insurance and Hospital Insurance (Medicare) Trust Funds. The money was repaid by 1986, after the 1983 reform had restored the solvency of the OASI Trust Fund.

27. There is a large political economy literature exploring the impact of economic crises on the prospects of structural reforms. See Williamson (1994) for an overview.

annul an ABM when the going gets tough, these mechanisms require the approval of a large majority in national parliaments or, in the United States, broad bipartisan support in Congress.

ABMs, an innovative recent development in other OECD countries, ensure that national pension systems entering a fiscal imbalance are brought back to long-term financial stability in an expeditious manner. They work in much the same way that the automatic cost of living allowances (COLAs) adapt Social Security benefit levels annually for inflation.[28] But whereas COLAs automatically protect the benefit adequacy and thus living standards of retirees, ABMs automatically secure the long-term financial sustainability of the pension system and thus also safeguard the intergenerational fairness of the pension system.

Well-designed ABMs have the political advantage of being automatic (as their name indicates) and transparent, and they go into effect long before a crisis point. They also specify how any future financial shortfall in a pension system will be made up and thus efficiently allocate any "pain" among workers and retirees.

Sweden has introduced an ABM for its new notional defined contribution (NDC) pension system (see chapter 6),[29] but of more direct interest to US policymakers are the ABM reforms introduced in Germany and Japan (the employees' pension insurance [EPI] system) in 2004. These countries' pension systems share the basic defined benefit design of Social Security and, as we saw in chapter 3, have mandatory pension systems that aim to provide average mandatory pension replacement levels roughly similar to Social Security.[30]

All mandatory OECD defined benefit pension systems that want to remain solvent at a fixed tax/contribution rate face at least three similar long-term challenges: rising life expectancies, leading to beneficiaries receiving benefits for longer periods; declining support ratios, as the number of workers per retiree drops with the retirement of the baby-boomers and long-term declines in fertility levels; and the financing of the inevitable

28. We saw in chapter 3 that the "automaticity" of Social Security's COLAs was introduced only in the 1970s and that prior to that, Congress had to legislate separately for each inflation adjustment.

29. Given that Sweden' introduced an NDC pension system, the country was able to base its ABM on the concept of "turn-over duration," the difference between the earnings-weighted average age of contributing workers and the benefit-weighted average age of pension recipients. If the turnover duration is, say, 33 years, then the pension system is, based on annual contributions, able to finance 33 years of pension liabilities. However, turnover duration as defined here is a meaningful concept only in an NDC system and not applicable to a standard defined benefit pension system. See Settergren (2001) for the technical details of the Swedish ABM.

30. See figure 3.1. All three countries target average mandatory pension replacement rate levels of 33 to 40 percent of average economywide earnings.

"legacy debt" carried forward to future generation from the inception of any defined benefit pension system, where the "first-generation" recipients receive more benefits than they contributed to the system.[31]

However, two major factors differentiate the situation that faced the German and Japanese defined benefit pension systems in 2004 from that of Social Security today. First, both Germany and Japan, as we saw in chapters 2 and 3, face a future of populations ageing much faster than in the United States and are likely to see large absolute declines in their workforces. Second, neither country had an earmarked "OASDI-type" public pension trust fund. For these reasons the outlook for their mandatory public defined benefit pension systems in 2004 was more serious than that facing Social Security today, and the scope of their ABMs correspondingly far-reaching. The latter matters, as ABMs are potentially very potent policy instruments with direct implications on the daily lives of millions of people.

The ABMs introduced in Germany (called the sustainability factor[32]) and Japan (termed macroeconomy indexation[33]) in 2004 were similar in design. Both aimed to guarantee that the future tax/contribution level required to maintain the pension system's fiscal solvency did not rise above a certain percentage of wages. In Germany, these maximum limits (split equally between employers and employees) were set at 20 percent in 2020 and 22 percent by 2030, up from 19.5 percent in 2005. In Japan, the ABM will prevent the tax/contribution rate (also split evenly between employers and employees) from rising above 18.3 percent of wages by 2017, up from 14.64 percent in 2006. In other words, the introduction of ABMs in Germany and Japan also possessed some of the traditional "delayed introduction of pension reforms" characteristic described in chapter 4. In both countries an additional purpose of the mechanisms is to moderate scheduled future increases in tax/contribution levels (already at levels significantly above US payroll taxes) to the mandatory public defined benefit pension system and thus ease future burdens on workers.[34]

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31. Note that, as discussed in chapter 3, it is improper to directly equate the narrow accounting-like concept of "legacy debt" carried forward in a country's defined benefit pension scheme with the much broader notion of "intergenerational fairness." Certainly, a defined benefit pension system that causes a premature collapse of government finances or requires a rapid rise in future contribution levels due to excessively generous benefit levels for initial generations of retirees is intergenerationally unfair. However, a defined benefit pension system is only one (admittedly large) public institution with the longevity to transfer wealth between generations. School systems, health care, and physical infrastructure are other examples, as are earlier public norms of elderly being cared for within the family.

32. See Börsch-Supan, Reil-Held, and Wilke (2003) and European Commission (2005).

33. See Sakamoto (2005) and Fukawa (2006).

34. Estimates for Germany indicate that without the ABM, the required tax/contribution rate would rise to 28 percent of wages by 2040, while for Japan the tax/contribution rate required without the ABM would be 23 percent of wages by 2025. See Sakamoto (2005).

Germany and Japan also chose measures that adjust the annual COLA benefit increase for any future change (i.e., decline) in the pension system contributor/beneficiary ratio.[35] They will thus cut pension benefits in proportion to the projected decline in the ratio of workers contributing to the pension system and the number of pensioners drawing benefits from it. But, as we saw in chapter 2, if Germany and Japan increase their current low labor force participation by tapping unused labor reservoirs and, in particular, raising the level of participation among women, the two countries will be able to blunt the effects of their projected decline in working age population and of the ABM. Nonetheless, the effects of ABMs in both countries are potentially very large. In Japan, for instance, the Ministry of Health, Labor, and Welfare estimates that the ABM would cause average replacement rates for the EPI pension to decline 2 to 14 percentage points by the 2040s, depending on the economic scenario (Sakamoto 2005). Axel Börsch-Supan, Anette Reil-Held, and Christina Wilke (2003, figure 4.3) similarly estimate potential gross benefit cuts in Germany of up to 15 percentage points by 2040.

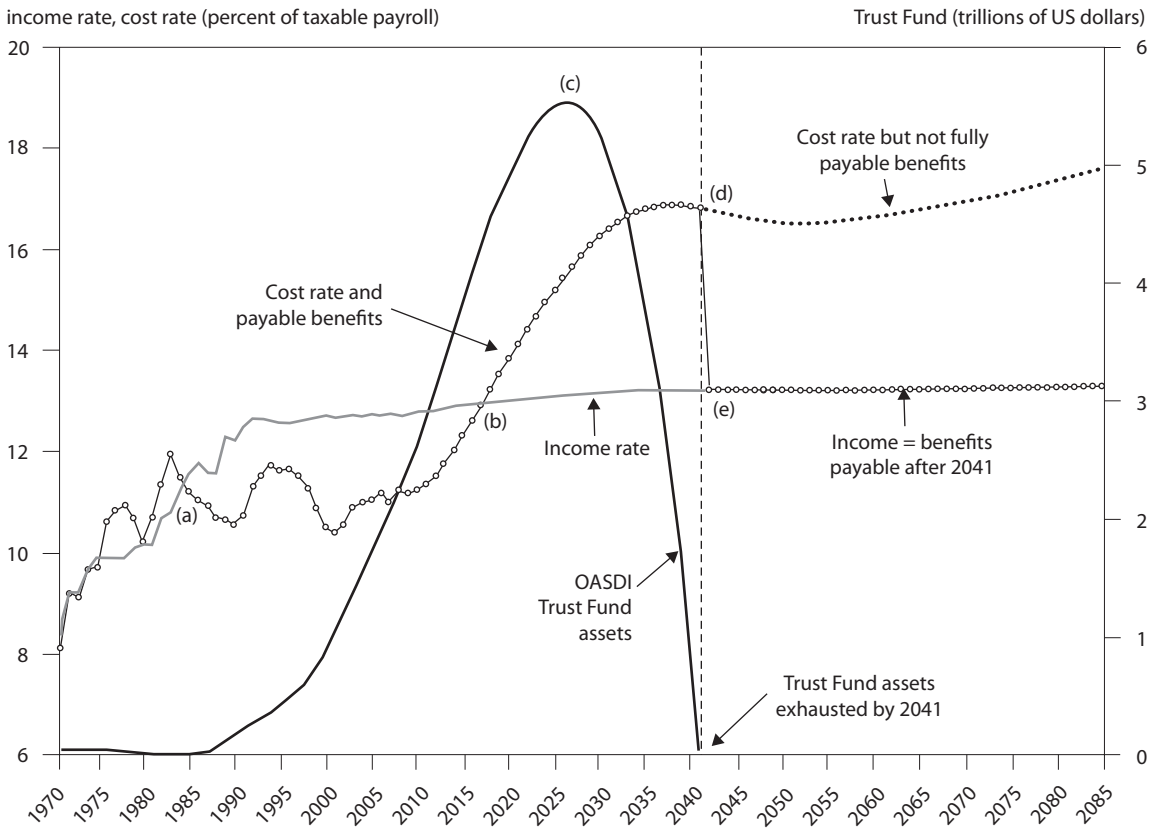
The ABM design chosen by Germany and Japan works in a way that reduces pension benefits for both current and future retirees and thus secures the long-term financial sustainability of the German and Japanese mandatory defined benefit pension systems exclusively via benefit cuts. However, as noted above, this seemingly one-sided ABM fiscal remedy was only one part of broader reforms in the two countries and, in fact, will work only to reduce the effects of already decided future tax/contribution increases. As such, the German and Japanese ABMs, in truth, are not one-sided measures aimed solely at retirees but rather can be said to be a balancing factor that ensures that long-term pension system sustainability is not achieved solely through continuously and already legislated rises in tax/contribution levels. They are subsequently a tool to help to begin distributing "the pain" of long-term pension system sustainability over as many generations as possible.

This distinction is crucial to US policymakers because current US law also has a de facto ABM in place to guarantee the long-term sustainability of Social Security. Figure 8.4 shows the most important financial indicators for Social Security from 1970 to the end of current projections in 2085 (intermediate scenario). We include disability pensions and show the relevant numbers for the entire OASDI program(s). As can be seen, the income rate[36] (thick grey line) rose rapidly from 1970 to 1990 and has surpassed

35. See Sakamoto (2005) and European Commission (2005) for detailed descriptions of how ABMs will adjust annual benefit indexation in Germany and Japan.

36. Equals the ratio of income from tax revenues on a liability basis (payroll tax contributions and income from the taxation of scheduled benefits) to the OASDI taxable payroll for the year. OASDI interest income is not included.

Figure 8.4 OASDI income and cost rates and Trust Fund size, projected to 2085



OASDI = Old Age, Survivors, and Disability Insurance

Source: OASDI Trustees (2008).

the cost rate[37] since the early 1980s, when the last major reform of Social Security brought forward scheduled increases in payroll taxes[38] (point a) and will continue to so until 2017 (point b). These higher levels of income led to the intended buildup of the OASDI Trust Fund, which rose (thick black line, right axis) from essentially nothing in the mid-1980s to a projected peak of over $5.5 trillion in 2026 (point c).[39] However, after 2026, with the larger numbers of Americans retiring and resulting increases in the OASDI cost rates to levels significantly above the income rates, the Trust Fund declines rapidly and will be exhausted in the year 2041. The retirement of the baby-boomer generation will lower the Social Security contributor/beneficiary ratio from its historical level (since 1974) of 3.2–3.4 to just 2.2 from 2030 on (OASDI Trustees 2008, figure II.D.3). Thus, although Social Security in 2017–41 goes through the same transition period that in Germany and Japan would lead to automatic adjustments in annual pension indexation, no automatic changes occur *during* the transition process (as in Germany and Japan); instead, in part because of the existence of the OASDI Trust Fund, they are postponed until the process is essentially finished by 2041.

At the point of OASDI Trust Fund exhaustion in 2041 (point d), Social Security can no longer continue to pay out benefits according to the original schedule,[40] and payments are automatically reduced to match only the continuous level of payroll tax income (point e). As a result, the Social Security Trustees in the 2008 report project the ability to pay only about 78 percent of scheduled Social Security benefits after 2041, dropping to 75 percent by 2082. This means that US Social Security has a built-in ABM that "guarantees" its long-term sustainability and function by imposing a universal benefit cut of 25+ percent beginning in 2041. Thus the entire "pain" of balancing Social Security's books will be borne by retirees after 2041.

But contrary to the ABMs in Germany and Japan, the US ABM is not part of a broader pension reform, such as increases in retirement ages and tax/contribution levels, which might distribute "the pain" among workers and current retirees. The US approach is thus extremely one-sided in

37. Defined as the ratio of the cost of the program(s) to the taxable payroll for the given year.

38. See overview of the 1983 amendments to Social Security legislation, available at www.ssa.gov/history.

39. The reason the Trust Fund continues to increase between 2017 and 2026 is that interest income from Treasury Securities held by the OASDI Trust Fund is included in the Fund's assets but excluded from the calculation of the OASDI income rate as it does not relate to payroll taxation.

40. See box 6.2 for the legal details of what happens, according to current US law, when the OASDI Trust Fund is exhausted. See also Romig (2006).

its use of automaticity to fix the Social Security solvency problem by simply cutting benefits for future retirees after 2041.

The crucial question is, who benefits from the current pension system design, implemented with the last big reform in 1983, which restored Social Security to long-term solvency solely by cutting benefits for retirees after 2041? Who benefits from the lack of either increases in contributions for present-day workers or cuts in benefits for today's retirees? The answer is that those (relatively old) current participants in Social Security, who will be dead—and thus have ended both contributions to and benefits from Social Security—before 2041 are the winners here. They will have contributed to Social Security at today's unsustainable rate of payroll taxation (given today's benefit levels) and will have received their unsustainable Social Security benefits (given today's payroll tax levels) and will thus be completely unaffected by the 2041 ABM. It is, perhaps, not a coincidence that these rules were written this way in 1983, as the principal beneficiaries will be the large and politically decisive American generations born after 1946.

Many argue that "Congress will never allow this to happen," that it is inconceivable that Social Security benefits would simply be cut by a quarter come 2041. Indeed, as we have shown in this book, such an across-the-board cut would certainly lead to wholly unacceptable increases in old age poverty. Yet for each year that Social Security reform is postponed, an ever greater number of Americans will avoid sharing any of the "pain" from putting Social Security back into long-term balance. If, for instance, the last minute reform scenario of 1983 were to repeat itself by the late 2030s in order to avoid unacceptable imminent benefit cuts in Social Security, the baby-boomer generation would have already largely passed from the scene and thus have avoided sharing any of the reform pain of making Social Security sustainable for the longer term. Therefore, while we have found that Social Security is not facing imminent financial collapse or "bankruptcy," this is not an argument in favor of not doing anything to reform it as soon as possible. The reason is one of simple intergenerational fairness—the longer any reform is postponed, the larger the share of the ABM effect borne by future generations. The fact that the current Social Security system will continue to function for several more decades must, therefore, never be a politically expedient excuse for failure to reform the system now.

Furthermore, while there are limitations to comparing reforms for very different pension systems, it is nonetheless illustrative to see that the ABMs in Germany and Japan, which operate much sooner than in the United States, may lead to a decline of approximately 15 percent in benefit levels by the 2040s, as compared to the roughly 25 percent benefit cut projected for US retirees in one fell swoop by 2041. In other words, postponement of the Social Security ABM so that it affects retirees only after 2041 will impose a significantly larger benefit cut on this group than is the

case for retirees in Germany and Japan, where the "pain" is distributed already today and across many more retirees.

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

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