EVENT SUMMARY

Release of *US Pension Reform: Lessons from Other Countries*

Jacob Funk Kirkegaard, Peterson Institute for International Economics
Martin Neil Baily, Brookings Institution

Peterson Institute for International Economics, Washington DC
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Presentation by Martin Neil Baily

Martin Neil Baily began his presentation by thanking C. Fred Bergsten and the Peterson Institute for International Economics, as well as the Ford Foundation for its financial support.

The book discusses a set of challenges facing public as well as private pension systems around the world. The original focus of the book was on private pension accounts, but its scope was broadened to include lessons from the pension systems of other countries.

One of the main conclusions of the book is that the US Social Security system has some virtues over other countries' pension plans, especially countries in Europe. First, it does not provide a level of benefits that discourages private savings. The United States has one of the largest stocks of private pension savings in the world. Second, the system does not unduly discourage work effort among people nearing retirement age. In Europe, many plans encourage early retirement. Since the labor-supply decisions of workers at retirement age are quite sensitive to different incentives in retirement plans, there are considerable differences among many countries.

On the downside, the US system is not very redistributive. Elderly widows in particular often end up in poverty. Hence, what is missing in the current Social Security system is more support for low-wage workers. The situation will only be aggravated if this demographic group does not receive more support with their healthcare costs from Medicare.

The authors therefore propose an add-on individual account program. People would be automatically enrolled in an individual retirement account with matching contributions from their employer.

What can be learned from other countries about the design of such a program? The Bush administration's proposal was well-designed and avoided many pitfalls from other countries. As for the funding shortfall, benefits can be cut or taxes raised. If benefits are cut, this should not be done across the board, but rather benefits should be increased for lower-income workers and cut for higher-income workers. There are a lot of tax breaks given to the private accumulation of pension wealth or tax-preferred pension programs in the United States, more than in other countries. The authors propose that tax deductions for employer pension or 401(k) programs should be recorded and that there should be a modest reduction in Social Security benefits for those who took advantage of these tax breaks.

Presentation by Jacob Funk Kirkegaard

Jacob Funk Kierkegaard began his talk by discussing the book's scope and methodology. The book looks at countries similar to the United States, especially OECD countries, using a historical, comparative approach. The results of this study are very broad and do not provide detailed reform proposals. But they do provide some insight into what a successful reform program would look like. Furthermore, the authors' approach is holistic, taking into consideration taxation, corporate, state and local pensions, etc.

Social Security went through a period of reform in 1983, which was quite early in comparison with other countries' pension systems, and the system remains relatively sound. The system is not in crisis, but it needs to be reformed in order to address future funding shortfalls.

The United States has very high levels of prefunded assets toward pension provisions because there have always been incentives for private savings, which has not been the case in many other countries. Taxes on pensions in the United States are relatively low, especially compared to Scandinavian countries. In addition, the authors factor in the costs of tax breaks. When these are included, the expenditures in the United States are actually higher than, for instance, in Canada and a number of European countries. However, countries with similar costs have more redistributive systems than the United States. In terms of sources of old-age income, the share of income provided by Social Security diminishes only among high-income groups. Hence, an equal reduction of benefits across all income groups is not recommended. Tax breaks disproportionately benefit higher-income groups. The United States is the only country where the income inequality is higher for the retired than it is for the working-age population.

As for the labor market, the effective retirement age has declined during the last few decades. The United States lies somewhere between Japan and Italy in terms of average retirement age. At the same time, life expectancy has increased, leading to a much longer time period during which people receive benefits from Social Security. Hence, to address the underfunding of Social Security, retirement ages should be directly linked with life expectancies after 2027.

The old-age poverty issue is not relevant for corporate pensions because those affected do not have access to these types of pensions. Loss estimates due to the financial crisis for US pension funds are around $1 trillion or 10 percent. Corporate pension liabilities are not a competitive disadvantage for US companies in comparison with other countries. But corporate pensions are more volatile in the United States than in other countries because a larger share is invested in equities.

As for state and local pensions, there is less cost control over these, so benefits continue to rise. As a result, many state pensions are severely underfunded. In order to fully fund their systems, state and local governments will have to cut benefits for the respective employee groups.

The authors propose cutting benefits for high-income groups by linking their benefits to the tax breaks they enjoy. Furthermore, they recommend life-expectancy linkages and add-on private accounts targeted toward low-income groups.

Questions & Answers

C. Fred Bergsten, Director of the Peterson Institute for International Economics asked what the magnitude would be of the add-on private accounts and how much would these measures add to net private savings. Martin Baily answered that he did not have an estimate for this second question, but that the magnitude of private accounts would be something like 2.5 or 5 percent of payroll to start. He also pointed out that add-on accounts could be redistributive, because they provide the infrastructure for low-income workers to save.

John Turner of the Pension Policy Center asked why the authors did not favor alternatives to their proposal, such as putting money directly put into Social Security. Martin Baily responded that individual accounts are a perceptual issue: People can see their money accumulating in their accounts, but they are not forced to have an account if they wish to opt out. In other countries, individual accounts had some positive effects.

Stephen Silvia of American University observed that the authors' proposal was very complex and asked whether there would be annual adjustments. He also wondered about the nature of the linkage between tax deductions and benefits and asked why the authors did not simply propose increasing the bend points of the existing system to make it more redistributive. Jacob Kirkegaard answered that they did envision an annual adjustment and that they would like to link the IRS and Social Security databases. Martin Baily stated that while their proposal is complex, it could be implemented in a very transparent way. Finally, Jacob Kirkegaard observed that while their plan would reduce the incentives for savings, according to the behavioral economics literature, the disincentives would not be extremely large.

Karen Johnson noted that the first recipients of Social Security benefits created a hole that has been shifted into the future and asked what other countries can teach us about these demographic issues. Jacob Kirkegaard replied that this legacy issue is a natural part of instituting such a system and little can be done about it. Martin Baily suggested some tax increases and benefit cuts to address the hole.

Fred Bergsten asked whether the authors were surprised, given the prevalence of these tax breaks, that private savings are so low, and wondered what this tells us about the effectiveness of these tax breaks. Martin Baily responded by saying first, that the authors are not arguing that these tax breaks are effective. Second, he observed that there is a paradox in that the stock of savings is high despite the fact that saving flows are low in the United States. Some high-income people save a lot, and in the United States access to borrowing is very easy.

Gary Burtless of the Brookings Institution noted that it may be more acceptable for people in the United States to have a voluntary increase in their savings rate than a compulsory increase in their tax rate and that people may trust at face value the tax concessions received from other sources, but these might not be accurate. He asked the authors how they would close the gap in light of this. Martin Baily responded that the latest numbers show that the gap is not huge, so the difference would come from raising taxes.

Alane Dent of the American Council of Life Insurers asked whether individuals would have access to their accounts or would the money be annuitized. Martin Baily answered that the authors lean toward not making too much of the money available prior to retirement, so as to ensure that people have the money when they retire.

Howard Rosen of the Peterson Institute for International Economics asked whether individual savings accounts would undermine the political support for Social Security and whether they would provide a disincentive for private companies to provide retirement assistance. Jacob Kirkegaard answered that there is not much evidence from other countries to support this argument. Martin Baily stated that their proposal is designed for low-income workers, who currently do not have private pensions.

Steve Weisman of the Peterson Institute for International Economics asked how the authors explained the 1983 reform's failure to produce sustainable results and wondered how they could convince people that their reform would be successful. Jacob Kirkegaard stated that the 1983 reform was not intended to solve the long-term problems facing Social Security. One way the authors' plan provides a more long-term solution is through linkages between benefits and life expectancy. Martin Baily also suggested increases in the retirement age.

Thelma J. Askey of the US Trade and Development Agency asked how the authors proposed tackling the issue of fees for managing these accounts given the range of investment options. Martin Baily answered that there would be a limited range of choices in their program.