



# **The Public Pension System in the U.S.: Assessing the Problems & Addressing the Challenges**

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That Social Security, the U.S. public pension system, will face major challenges in coming decades is not news to anyone in this room. At the root of the problem are a number of factors, including: 1) The upcoming retirement of the large baby boom; 2) Growing life expectancies; 3) Declining birth rates; 4) The maturation of a pay-as-you-go system, where the earliest generations received large windfalls, leaving the existing system with large legacy costs; and 5) The use of government trust funds to pre-fund Social Security. Or put another way, the population, which was once pyramid shaped, is no longer, and the partially government pre-funded, partially pay-as-you-go system is not designed to deal with the ensuing challenges. Moreover, because Social Security benefits are indexed to wage growth, we cannot simply “grow” our way out of the problem no matter how strong the economy.

## **Background**

I'll start with a few numbers to fill in the picture. In 2008, the Social Security surplus, currently used to finance the rest of the government, will start to shrink rather than grow, adding additional pressure to the budget. In 2018, Social Security tax revenues will no longer cover benefits. The program's trust funds will have paper assets to cover benefits through 2041 but repaying the trust funds will require increasing taxes, reducing government spending, or borrowing -- the same options that will exist once the trust funds are exhausted.

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In present value terms, we would have to put aside \$3.5 trillion today to create a reserve to fill in the gap between taxes and promised benefits for the next 75 years. To create a reserve to make the program sustainable rather than just balanced over the actuarial period, we would have to set aside \$10.5 trillion. That number grows to roughly \$44 trillion when one includes the Medicare program.

In order to achieve permanent balance, Social Security benefits would have to be cut immediately by 25% or payroll taxes increased by 30%. Every year of delay adds to the costs. However, these numbers assume that the trust funds work as a way to smooth out costs, which, currently, it is not clear that they do. Recognizing this, the tax increases necessary to maintain balance grow to 49% in the final year of the 75-year actuarial period (and continue to grow thereafter) or the benefit cuts grow to 33%.

Finally, Social Security will grow as a share of the economy from 4.4% of GDP today to 7.0% over the 75-year actuarial period. The country's three major entitlements programs – Social Security, Medicare and Medicaid – are expected to basically double from a combined 7.6% of GDP today to 15.5% by the year 2040. Keep in mind that rarely does the federal government exceed 20% of GDP, so this means either a dramatic change in the size and shape of government, or draconian reductions in spending in all other areas.

A second area of concern for retirement policy in the U.S. is the state of the private pension system. Roughly half of workers are covered by private pension plans and due to the structure of the tax subsidization of benefits, coverage is highly skewed toward the top half of the income spectrum.

Then there is the issue of personal saving. If there is one area of U.S. economic policy where there is rarely any attempt at self-congratulation, it is our personal saving rates. Private saving is stubbornly low, which hurts both over-leveraged individuals and the economy at large. Many economists believe that the structure of Social Security, which promises workers who live to retirement age a steady, inflation-adjusted retirement benefit, reduces personal saving rates since workers feel less of a need to save on their own. Low saving rates in turn dampen economic growth.

On top of that, structural public sector deficits are adding to rather than mitigating the problem.

While experts across the board pretty much agree that changes have to be made to address the financial shortfall in Social Security, and that the sooner they are phased in, the better, there is less agreement in the political arena. Disagreement about the magnitude of the problem tends to be as tactical as it is anything else. Those who favor reforms that need to be instituted in advance of the last possible moment - such as creating individual accounts - tend to accentuate the severity of the problems, while those who favor only incremental changes, tend to downplay them. However, it is fair to say that something will have to be done: We cannot continue to ignore the demographic boulder rolling towards us.

It is true that the problems within the Social Security system pale in comparison to the U.S.'s public health care system, Medicare, whose unfunded liabilities are roughly five times as large as those in the pension system. Likewise, other countries' aging challenges are much larger than those we expect to see here. However, both of these perspectives make me feel worse not better. There will be double demand on the nation's resources to contribute to fixing both Social Security and Medicare. And because we have delayed in making these changes, the same generation is likely to get hit with the costs of fixing both, when changes could have been phased in more gradually and fairly. Also, as other nations are struggling to pay for their own age wave, the capital inflows the U.S. has become so accustomed to are likely to dry up, potentially creating a new set of economic challenges for the U.S.

### **Objectives of Reform**

There are a number of - sometimes competing - objectives that drive decisions about what changes should be made to the retirement system. First, there is the goal of making the system sustainable and by that I mean ensuring not just that we push into the future the year when deficits will begin, but rather that we alter the system so that it becomes structurally sound.

Second, one must look at the issue from an overall budgetary perspective rather than just a singular, compartmentalized, programmatic perspective. Currently in the U.S., the federal government spends \$8 per senior for every \$1 it spends on children - and this number will continue to grow. A continued emphasis on consumption-based transfer programs at the expense of public investment does not bode well for future economic growth, nor does it allow the level of flexibility one would ideally want built into the budget.

Social Security needs to continue to provide adequate benefits. In a country this wealthy, it is not unreasonable for the government to guarantee that any person who works a full working lifetime not fall below the poverty line in retirement. This still leaves room for benefits reductions, but implies that they should be structured to protect those who most rely on the program.

In order to grow the economy to reduce the burden of paying for future benefits, the U.S. needs to increase its national saving rates. There are two approaches directly linked to Social Security reform that can potentially help increase saving: Using Social Security surpluses to decrease government dis-saving, or to increase private saving. However, both are vulnerable to structural weaknesses. Government pre-funding can potentially lead to larger spending programs and tax cuts rather than higher government saving, while higher individual saving can lead to substitution out of other personal saving vehicles.

A final objective should be to spread the costs fairly among individuals and generations. Decisions must be made about how much to protect current retirees and thus shift more of the cost to future generations. Giving participants time to adapt is not the only consideration, their financial ability to do so is also important and needs to be considered.

### **Major Areas of Disagreement**

Now I want to discuss the major areas where efforts to make changes tend to breakdown.

Benefit Cuts v. Revenue Increases - The debate about benefit cuts versus revenue increases breaks down pretty neatly into ideological boxes with Republicans favoring benefit reductions, usually in the form of altering how benefits are calculated from wage indexing to price indexing, and Democrats favoring revenue increases, usually in the form of lifting the existing payroll tax cap. However, few politicians are willing to publicly articulate a preference in either direction and many prefer to defer the choices of how to rebalance the nation's retirement system.

Defined Benefit (DB) v. Defined Contribution (DC) - Social Security is currently a defined benefit system. Proponents of DBs are concerned both that the private sector is already switching away from defined benefit plans towards DCs and that creating a hybrid Social Security system with one DB tier and one DC tier could open the door to participants preferring the individualized account portion of the system, thus leading to the unraveling of the existing structure.

Pre-Funding v. Pay-as-you-go - Those who are concerned about the mounting costs of Social Security tend to believe that pre-funding at least a portion of the system is an important way to spread the costs. This was the reasoning behind the 1983 reforms, which made changes in advance of when they were needed, in order to build up the Social Security trust funds. Others have argued that there is no need to pre-fund Social Security since standards of living will be higher for future generations and they will thus be able to afford to pay more.

Government v. Individual - Assuming a portion of the system is pre-funded, should it be government or individuals who store the saving? Again, this goes back to the issue of whether the trust funds have been effective -- and this is one of the key debates here in the U.S. Let's assume there is government pre-funding. If the additional surpluses do not serve to increase saving, but instead affect how much budgeters see as theirs to spend, future workers are no better off than if the surpluses had never existed. (I would actually argue that this policy is worse than doing nothing because the resulting lower taxes and higher government spending will also put additional pressures to future generations on top of their obligations to repay the Social Security and Medicare trust funds.)

Instead, trust fund assets could be invested in private equities rather than government bonds to insulate the money from the rest of government. It must be noted, though, that there are large political risks in allowing the federal government to own such a significant share of the stock market and the large sums could pose liquidity problems for markets.

Individual accounts could also serve to insulate the funds from the rest of government. However, in order to increase savings, the accounts must constitute new saving, not just a substitution for existing saving.

Benefit Cuts v. Revenue Increases v. Borrowing - If individual accounts are used to pre-fund Social Security, then there is the issue of how to pay for accounts, which require upfront costs – as does any form of increased pre-funding - that must be paid for either through spending reductions, tax increases or borrowing. Sadly, the movement in the U.S. now tends to be towards borrowing to create accounts, which of course undermines efforts to increase national saving.

Government Risk v. Individual Risk - A second issue is who would bear the risk: Generally under a DC plan, the risk would be borne by individuals. However, more and more plans in the U.S. are including guarantees of set levels of benefits. Such reforms in effect shift the government's

unfunded liabilities to contingent liabilities. If the government does go this route, (and I would argue that it should not,) appropriate budgeting for these types of costs will be necessary.

Regulations v. Choice - Finally, there is the issue of how tightly to regulate accounts. This in part depends on the structure of the system. If the accounts are voluntary or on top of the existing Social Security structure, there is less of an argument for strict regulations whereas if they are used to replace a portion of the existing system, one may want to require things such as no pre-retirement withdrawals and inflation-protected annuitization in order to mirror aspects of the existing system.

So, let me conclude with three points:

The big question is from where will the impetus for the inevitable reforms come? One possibility – and not a particularly pleasant one - is that if we wait too long, financial markets will start to price in these liabilities, which could lead to a pretty unpleasant financial meltdown. Such a meltdown could be hastened by implementing improved accounting to track our long-term liabilities, which by all means we should do. By this I mean either the use of accrual accounting in relevant portions of the budget, or tracking and limiting unfunded liabilities as we do our national debt, and extending our budgetary analysis beyond five and ten year windows. However, while increased transparency is needed to shed light on the challenges we face, implementing such changes could have a very disconcerting effect on markets.

Second, the country is going to have to grapple with the true meaning of social insurance. We have long confused social insurance and universal benefits. There is a difference between insuring that all retirees are protected against poverty in old age and promising higher levels of benefits – universal in nature regardless of need – which can lead to the all too common situation of low income workers handing over a tenth of their income to more affluent retirees. Our decision on which model to pursue in the future will likely have a profound affect on the size of our federal government.

Finally, it is my concern that issues of generational equity will be lost in the debate. We know these problems are looming around the corner and yet we continue to delay in making necessary changes. The longer the ongoing delays, the greater the expense to younger workers and future generations, and I fear, the economy.

With that I will close, thanks very much.