

The Big Picture: Paying for Retirement

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INTRODUCTION

True or false? The federal government is little more than an ATM for seniors that manages the Armed Forces on the side. How one responds to the quip is a good indication of how one views the growing costs of retirement in the United States. There are those who nod their heads in agreement (a group that generally believes we need to implement significant structural reforms), and those who roll their eyes at the exaggeration (a group more content to make incremental changes and, oftentimes, wait until it becomes absolutely necessary to do so).

The issue however, is broader than just the share of government resources dedicated to retirement costs, which can include everything from Social Security and pension benefits, to health insurance and direct healthcare costs, to foregone tax revenues used to encourage individual saving for retirement needs. A comprehensive look at the question of how we will pay for retirement costs in the future must look at what share of the entire economy is dedicated to the nonworking elderly, and to what extent we defer consumption today in order to allow ourselves to consume more tomorrow.

In taking a comprehensive view of paying for retirement, there are a number of issues that must be considered. These include: 1) What share of national resources should be dedicated to retirement costs; 2) How should the burden of paying for retirement costs be distributed; 3) Who should shoulder the risk; and 4) What structures should be used.

Share of Resources

If we allow the federal government's two major retirement programs -- Social Security and Medicare -- to grow on their current projected path, they will continue to consume an ever-growing share of GDP, more than doubling to nearly 15 percent of GDP by 2050. Significant growth in the cost of government employee and veterans' pensions will also add to the budgeting dilemma legislators will soon face. These circumstances give us three alternatives: 1) Whether to raise taxes to cover all the promised benefits and grow the government to unprecedented levels; 2) Whether to reduce other areas of government spending in order to make room for higher retirement costs, squeezing out other important areas such as public investment, defense, and safety net programs; or 3) Whether to slow the growth of promised retirement benefits.

While there are legitimate arguments in favor of each of these approaches, 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. Certainly, the past couple of years have illustrated that there is no way to confidently anticipate all future budgetary needs, whether in the area of national security, the environment, or helping to smooth out rocky transitions in an increasingly global marketplace. Allowing ample room in the budget to cover unexpected costs is a necessary component of prudent budgeting.

As the public sector faces the strains of an aging population, so too will the private sector. Though the trend of companies shifting from defined-benefit plans to defined-contribution plans is steadily underway, there remain a number of defined-benefit plans in place and as of last fall, they were underfunded by roughly \$400 billion. Making good on these retirement promises will shift more of company resources away from basic costs including compensation and investment. This, in turn, will depress businesses and economic performance in the future compared to what it would otherwise have been. And as market barriers continue to decrease and global competition heightens, these additional costs will leave U.S. businesses at a competitive disadvantage.

Who Pays

There are only three options for who pays for the major retirement expenditures: Governments, businesses, or individuals. Depending on one's objectives, there are different rationales for making use of each.

If the objective of retirement policy is to force individuals to prepare for old age, then government mandates are most effective. By removing the elements of choice that exist in voluntary employer-based pension schemes or individual saving approaches, universal coverage of target populations is ensured. (Public/private hybrid approaches, where the government uses the tax code as a "carrot" to encourage individuals to prepare voluntarily for their own retirement, can be less successful since those who take advantage of the tax incentives would often have engaged in the behaviors even in the absence of the incentives. More importantly, those who would not have, oftentimes, still don't.)

Likewise, a centralized provider such as the government, is best equipped to counteract typical insurance market failures such as adverse selection problems. Thus if it is determined that some kind of catastrophic health insurance policy should be required for the entire population, the government would be instrumental in providing such a mandate and creating the risk pooling mechanism.

Finally, if there are redistributive objectives in creating retirement security – such as including subsidies from rich to poor or from workers to stay-at-home-parents – so that certain groups of retirees will receive windfall benefits, government involvement is necessary.

Businesses can also play a very useful role, particularly in serving as automatic and centralized administrators of programs. 401(k) programs, for example, have benefited greatly from the automatic deduction options provided by employers and take-up rates are clearly much higher than they would be if businesses were removed from the equation. Another major contribution businesses can provide is a risk-pooling mechanism for health insurance,

allowing both workers and retirees to participate in private plans they could not otherwise buy into on their own.

Obviously, there is a role for individuals in preparing for their own retirement needs. This for the most part comes down to the importance of individual saving both to compensate for lost employment income and to cover the cost of future medical care whether it be for insurance premiums, co-payments, or direct medical costs. In the end, of course, individuals pay for retirement costs no matter what pass-through, centralizing, or administrative mechanisms are used to provide them. In the case of the government as provider, individuals bear the costs through taxes. In the case of employer-provided benefits, the cost comes back to individuals in the form of lower wages to workers, higher prices to consumers, or lower returns to investors.

Who Bears the Risk

Related to the issue of who pays for retirement costs is the issue of who bears the associated risks. In the past, retirees have been insulated from most risks. In the earliest decades, Social Security benefits were more likely to be larger than promised, not smaller, and most private pensions were defined-benefit plans. These arrangements left the government (meaning tax-payers) as opposed to recipients, and employees and investors rather than retirees shouldering the risk of higher than anticipated retirement costs.

More recently these trends have been shifting. Significant Social Security benefit reductions were signed into law in the 1983 reforms. And benefit reductions are highly likely in the future to help contain the program's costs and close the programmatic deficits. As the debate continues about whether to include integrated individual accounts as part of a modernized Social Security system, the issue of risk is one of the major dividing lines. Opponents of private accounts cite the investment risk that retirees would face if their individual accounts portfolios under-performed. But the political risk that promised benefits will be cut is equally as important a consideration.

Furthermore, it will no longer be as easy or as fair to insulate retirees from all the types of risk they might face in retirement now that the population is no longer pyramid shaped. Asking workers in the case of employer-based benefits, or payroll taxpayers in the case of government-provided benefits, to shoulder all the risks while insulating retirees makes little sense, particularly when many workers are less well off than retirees. A smarter strategy would be to diversify the types of risks that are faced and to spread them more equitably across the entire population, also taking into consideration one's ability to shoulder certain risks.

What Structure

There are a number of approaches to crafting retirement policies. First, the government can provide direct-spending programs or businesses can include defined-benefit pension programs as part of their compensation packages. This approach involves direct outlays either by the public or private sector. Since defined-benefit plans are generally reinsured by the government, tax payers still face liabilities.

An alternative approach is to use incentives. The government employs a number of tax incentives to encourage individuals to save on their own behalf, including the deductibility of many types of retirement saving. Likewise, employer-provided matches for 401(k) accounts are an example of privately provided incentives. Finally, the use of mandates or regulations can also be a part of structuring retirement policy. For instance, there is a growing interest in mandating individual self insurance for those without health coverage through other providers. A number of Democratic presidential candidates have proposed insurance mandates to cover children. ERISA laws are another example of requirements that are used to expand coverage and participation.

POTENTIAL STRUCTURAL CHANGES

Beyond the basic issues I have just mentioned, there are a number of larger, conceptual issues that I believe need to be addressed. These issues include: 1) The need to increase

saving; 2) The distinction between social insurance and social benefits; 3) The optimal role for employers in providing benefits; and 4) The need to control healthcare costs.

The Need for Saving

Higher levels of saving and investment and ensuring higher levels of productivity will reduce the burden of paying for future retirement benefits. For that reason, low personal saving rates, which are now exacerbated by the return of structural government budget deficits, are particularly troubling in that they hurt both over-leveraged individuals and the economy at large. Thus far, our strong reliance on foreign capital for investment has not proven to be overly burdensome for the economy. However, declines in the dollar and the fact that other countries around the world will also be contending with their own demographic challenges imply that continued reliance on foreign capital going forward could leave the U.S. economy in a severely weakened position. Therefore, policies that would enhance personal – and national – saving would have the dual benefit of both setting aside resources today to help pay for benefits in the future while strengthening the economy in so doing.

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. Likewise, the presence of the Medicare program reduces the need for individuals to save for future costs of their own medical care. Thus, it is not surprising then that the expansion of insurance and government benefits for health and pension needs has been correlated with lower levels of personal saving.

If indeed it is decided that the way in which we pay for and deliver our retirement benefits needs to be consistent with the objective of increasing national saving, there will have to be a shift towards policies that either increase government saving, require businesses to set aside resources with which to pay promised benefits, or encourage – or require – individuals to save in order to cover a portion of their own expenses. Furthermore, any such policies will need to be structured to create *net* increases in national saving rather than just higher levels of saving in one area of the economy that are offset by lower levels in another.

Social Insurance or Social Benefits

The United States is going to have to grapple with the question of, “What is the true meaning of social insurance.” Our largest government programs, Social Security and Medicare, treat social insurance and universal benefits as one and the same. However, there is a difference between insuring that all retirees are protected against poverty in old age or catastrophic healthcare costs and promising benefits that are universal in nature regardless of need. The latter, which describes our current social contract, leads to the all too common situation of low-income workers supporting more affluent retirees. The universal nature of these programs is as much political – designed to ensure ongoing political support – as anything else. However, the immense cost of the universal, non-needs-based structure will certainly become more difficult to accommodate as budgetary pressures increase.

An alternative structure would be to focus more on the insurance aspects of the social contract. All citizens who had contributed over their working lifetimes would be covered against living in poverty in old age and catastrophic healthcare costs. Beyond that, retirees of low means could be subsidized further both in terms of income support and healthcare, either on the saving end during the working years or the benefits end during their retirement years. Significant savings would be realized from shifting the qualifications for government transfer programs from age to need, moving away from a system of universal benefits to one of true social insurance.

Role of Employers

A third issue is the appropriate role for employers in providing retirement benefits going forward. Employers are now viewed as an integral part of the social contract but the origin of this arrangement was an accident of history dating back to wage and price rationing during World War II. The resulting reliance on employers to play a central role in providing both health and retirement benefits has both positive and negative effects. On the one hand, employers provide the very useful services of automatic withdrawals for retirement saving and risk pooling for health insurance. On the other hand, linking retirement benefits to jobs can hinder job mobility and often-times creates job lock. Moreover, it perpetuates

the misconception that the responsibility for preparing for retirement can and should be shifted to someone else while in reality the costs are shifted back to individuals through a variety of less transparent channels.

Furthermore, the tax-based incentives that encourage employers to provide such benefits are both highly regressive and increasingly ineffective. Exempting employer-provided healthcare and retirement benefits from income for tax purposes leads to an upside-down incentive in the tax code that provide the largest tax breaks for those who need them least. Furthermore, these tax breaks, which amount to some of the most expensive tax expenditures, contribute to the complexity and inefficiencies in the income tax code. Finally, as the ongoing shift from an income tax to a consumption tax continues, it will be increasingly difficult to use the tax code to create targeted incentives for saving for particular groups of people or purposes.

Containing Healthcare Costs

Finally, it will be absolutely necessary to figure out ways to contain spiraling healthcare costs, which currently are the largest driver in the projections of the unsustainability of the federal government's largest programs. While healthcare rationing is not even a topic of national discussion it is quite likely that it will have to be in coming years.

Beyond that however, a structural reworking of how health insurance functions – the incentives built in the system and what is covered – could make a significant difference. Currently, healthcare consumers are far too divorced from the actual costs of the healthcare services they receive. The first reason is that with so many healthcare goods covered by insurance, over-consumption results. Furthermore, prices are not transparent, so even a consumer who is attempting to be price conscious has a difficult time doing so. Finally, the subsidies and favorable tax treatment of both health insurance and health consumption can lead to over-consumption as well as higher costs. In general, you don't insure your house for gutter cleanings but you do for fire damage. You don't insure your car for oil changes but you do for collisions. And yet, healthcare insurance coverage normally covers such routine procedures as dental cleanings, eye exams and checkups. At the same time, certain healthcare

costs are capped, undermining the basic purpose of insurance to kick in and alleviate large financial burdens. Thus a fundamental reworking of the health insurance market with the objective of re-linking consumers to ongoing, predictable costs while protecting them against unanticipated and overly burdensome ones, could help contain spiraling healthcare costs.

CONCLUSION

The section above includes ideas for major structural changes in how we deliver retirement benefits. I will conclude with two predictions. I believe that both are likely to occur whether or not a scenario such as the one I just laid out is implemented.

The first is adoption of flexible retirement ages. The retirement crisis we will face is as much a labor market problem as it is anything else. Finding ways to encourage individuals to spend more of their living years in the workforce and fewer in retirement will be crucial in containing retirement costs and ensuring that retirees are sufficiently provided for once they do retire. The notion that a single retirement age best meets the individual needs of hundreds of millions of workers is clearly wrong. Many who become disabled actually need to retire earlier than the current normal retirement age while many more will find that they are both eager and able to stay in the workforce longer.

Secondly, I believe that individual accounts will most certainly play a greater role in preparing for retirement. Whether these accounts are used to augment or replace existing government and employer-based programs, it seems certain that they will become more of an integral part of the basic social contract. Accordingly, public policies will inevitably respond to the more widespread use of individual accounts for retirement. First, low levels of financial literacy in the country will have to be addressed. Furthermore, given the significant share of the population that is currently unbanked, both public and private sector efforts are likely to emerge to link citizens to financial institutions. The annuities market, which remains relatively underdeveloped in the United States, will likely grow significantly. Beyond just providing a mechanism to guarantee that individuals cannot spend down all their savings, annuities provide important signals about adequate saving levels. For instance,

by looking at annuity prices, a 55-year-old can see whether he is on track to retire with a monthly income that will meet his needs and thus, whether he needs to start saving more (or less) or plan to work longer (or shorter) than he had planned. Finally, one of the problems with most of the nation's saving policies – particularly in the area of housing and 401(k)s – has been increasing popularity of borrowing against one's savings in these areas. Since entering retirement with an individual saving account and a corresponding liability will do little good covering retirement costs, I believe it is likely that new regulations against borrowing against many of these tax favored or mandated savings vehicles will sooner or later be implemented.

I have covered a lot today and much of it will be controversial, but I hope that at the very least it will help spark a much-needed conversation about how we will pay for retirement costs in the future.