Social Security on Auto-Pilot: International Experience with Automatic Stabilizing Mechanisms

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Social Security’s Finances

- Program outlays began to exceed tax revenues in 2010
- Projections show that system can remain solvent until 2036, at which point benefits will have to be cut by 25%
- Actuarial deficit = 2.2% of taxable wage
- A large part of this funding crisis is due to the retirement of the baby boom generation
- If taxes had been raised while the baby boomers were still working, situation would be much better
Social Security Costs and Income, 1970-2086

Source: Social Security Administration website, May 2011.
System parameters are adjusted over time according to movements in actual or projected changes in demographic indicators, economic performance, or the financial status of the pension system.

- Triggering mechanism
- Default adjustments

ASMs act as an insurance policy to keep pension systems in line

Provide means of rebalancing retirement income systems in a way that minimizes political risk
Swedish Experience

- Prior system consisted of a flat-rate basic pension, an earnings-related national supplementary pension, and a means-tested pension supplement
- In 1998 the flat-rate and earnings-related pensions were converted to a Notional Defined Contribution Pension
  - Fixed tax rate of 16 percent
  - Benefits based on contributions over entire working life
  - Automatic balancing mechanism corrects for life expectancy and slow wage growth
- Balance mechanism triggered pension cuts in 2010 and 2011 but it was revised to slow adjustment and effects on benefits were partially offset by changes in pension taxation.
Canadian Experience

- Multi-tier system with a large quasi-universal flat-rate pension, an income-tested tier, and a contributory social insurance plan
- In 1997 agreement on changes reached that included:
  - Increased tax rates for employers and employees,
  - Automatic trigger based on 75-year actuarial deficit,
  - Default policy of benefit freeze and tax increase.
- System has been sustained without a triggering event, although some controversy over projections in early years.
German pension system relied on single contributory social insurance tier

Demographic problems exacerbated by German reunification

1997 legislation linked retirement age to life expectancy, but repealed when new government took over.

Added an individual account in 2001.

Pension reform in 2004 included the automatic adjustment tied to actual dependency ratio.

With the 2009 elections, government suspended some reforms and evaded others. Complicated by need for stimulus in financial crisis.
Italian Experience

- Had an unsustainable Pay-As-You-Go pension system with fragmented collection of multiple pension schemes and low retirement ages, as well as a means-tested old-age benefit
- Flawed and lagged NDC system enacted in 1995 for younger workers
- Numerous ad hoc reforms enacted before and after 1995 reform
- NDC adjustment schedules for 2005 delayed
International Outcomes

- Canada—Not triggered, though some controversy over future projections.
- Sweden—Sustained but partially evaded
- Germany 1—Repealed
- Germany 2—Temporarily suspended
- Italy—Suspended, modified and supplemented
ASM Lessons for Policymakers

- Actuarial deficit is a reasonable standard for Social Security sustainability plans (Simple clear trigger, used in Canada)
- ASMs are not a panacea, but can be part of a package
  - Can be used on revenue side and benefit side
  - Should be phased in to avoid highly visible losses that could result in repeal
  - Needs to begin with financial balance – works as insurance
- ASMs pose high risks to low-income seniors, so protections for this group are critical
Application to the United States

- ASMs already a part of the US pension system
- Wage and price indexation of the earnings tax base and benefit payments stabilizes share of earnings subject to taxation and maintains the real value of benefits
- This controls for economic trends
- Need provisions that also control for changes in demographic trends
- All of projected increase in cost rate can be traced to changes in demographic factors
Demographic and Economic Determinants of the Cost Rate, 1970-2086

Source: Social Security Administration website, May 2011.
Policy Suggestions for the United States

- Index the retirement age to stabilize the ratio of retirement life to work life.
  - After 2022 increase at a rate of one month every 2 years
  - Estimated impact is 0.4 percentage points of taxable payroll
- Change the indexation of taxable wage ceiling to maintain a 90 percent ratio of taxable wages to covered wages
  - Estimated impact is 0.75 percentage points of taxable payroll
- Still requires active policy changes equal to about 1% of taxable payroll.
- Introduce ASM targeted on actuarial deficit as insurance policy --follows Canadian default policy.
Effects of Two Reforms on Financial Condition of the OASDI Fund, 2010-2085

Cost and Income Rates

<table>
<thead>
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<th>Year</th>
<th>Current Law Income Rate</th>
<th>Current Law Cost Rate</th>
<th>Post-Reform Income Rate</th>
<th>Post-Reform Cost Rate</th>
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Trust Fund

Percent of Current Law Taxable Payroll

2010: Current Law - 50, Post-Reform - 40
2020: Current Law - 40, Post-Reform - 30
2030: Current Law - 30, Post-Reform - 20
2040: Current Law - 20, Post-Reform - 10
2050: Current Law - 10, Post-Reform - 5
2060: Current Law - 5, Post-Reform - 2.5
2070: Current Law - 2.5, Post-Reform - 1
2080: Current Law - 1