

The U.S. Pension System and the U.S. Debate over Pension Reform

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For **Lisbon Parliamentary Seminar on Pensions
Sustainability**

May 2006
Lisbon, Portugal

National pension systems

- Portugal: Four pillars --
 1. Means-tested social assistance / top-up supplement
 2. Public, contributory earnings-related pension
 3. Private, voluntary occupational pension
 4. Private, individual, and voluntary personal savings
- U.S. system also has four pillars --
 1. Means-tested social assistance (noncontributory)
 2. Public, contributory earnings-related pension
 3. Private, voluntary occupational pension
 4. Private, individual, and voluntary personal savings

National pension systems

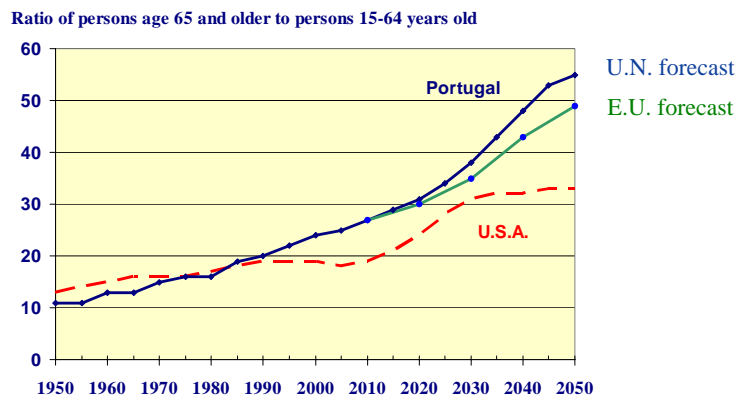
- Portugal's system places heavier weight on public pillars:

	Portugal	USA
Contribution rate for Old-age & survivors:	19.7%	10.7%
Contribution rate for Disability:	3.4%	1.7%
Total for Old-age, survivors & disability:	23.1%	12.4%

- Portugal system places less weight on occupational, employer-sponsored pensions than U.S. system
- Occupational pensions have more assets in USA:
 - 95% of GDP in USA vs. 11% of GDP in Portugal
(Estimates by OECD for 2004.)

Portugal & US forecasts differ

Old-age dependency burden (1950-2050)



Sources: United Nations and EU.

USA's public pension experience has been favorable so far

- **US** public system has been efficient and fairly successful
 - One basic plan, which covers 95% of workforce
 - Excluded workers employed by state & local governments
 - Uniform benefit formula
 - Little tax evasion
 - U.S. public pensions are modestly generous:
 - Average worker who retires at the full retirement age (65-66) receives 42% **gross** replacement rate / 50% **net** replacement rate
 - [For Portugal: EU estimates that public pensions provide 75% **gross** replacement rate / 91% **net** replacement rate]
 - U.S. program has large and growing financial reserves (15% of GDP)
 - Very efficient administration

USA's occupational pension system is less comprehensive, less secure

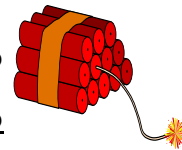
- **US private** or *occupational* pension system is funded
- It covers about 50% of full-time wage and salary workers
 - A higher percentage of older workers
 - A higher percentage of public employees
 - A higher percentage of high-wage workers
- Private company pension plans are regulated by U.S. tax authorities and the U.S. Department of Labor
- Private companies' defined-benefit pensions are insured by U.S. government agency, the Pension Benefit Guarantee Corporation

USA's occupational pension system is less comprehensive, less secure

- Since 1980, occupational pensions have moved away from defined-benefit pensions
 - DB pensions once covered the great majority of workers in occupational plans)
 - In spite of law requiring full funding, many plans have less funds than needed to pay for pensions when sponsoring firm goes bankrupt
- Public and private employers have moved toward defined-contribution plans
 - Firm contributes fixed % of pay to worker retirement accounts
 - Workers bear the financial market risk of low investment returns

What's the problem in the public pension program? (2005 Trustees Report)

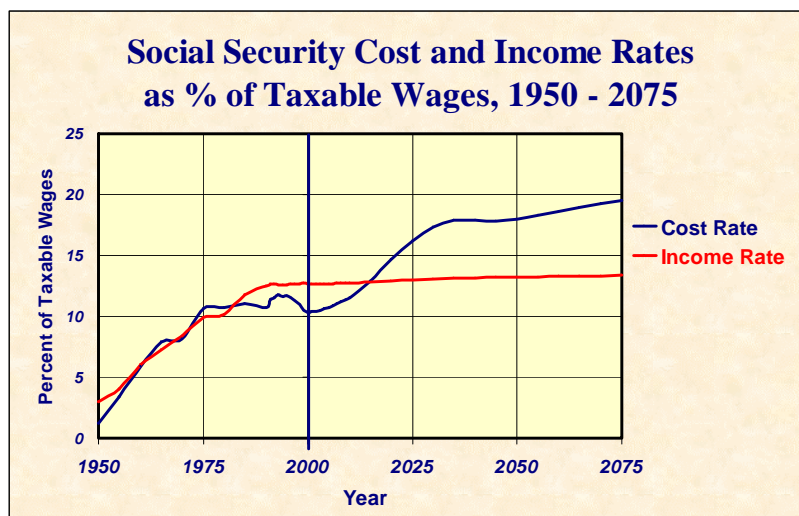
- Funding gap
 - Present value of liabilities: \$35.2 trillion
 - Present value of taxes: \$29.5 trillion
 - Assets in Trust Fund: \$ 1.7 trillion
 - Unfunded liabilities: \$ 4.3 trillion
 - Current revenues (% payroll) - 13.9%
 - Rate needed for 75 years - 15.8%
- Shortfall* --- -1.9% (of taxable wages)



But the funding shortfall is a long way off (2005 Trustees Report) ...

- **Income:** Payroll taxes (\$554 billion)
 Other taxes (\$ 16 billion)
 Interest inc. (\$ 89 billion)
- **Outgo:** Benefit payments(\$495 billion)
 Administration (\$ 4 billion)
- **Taxes will fall short of benefit payments: 2017**
- **Income will fall short of benefits: 2028**
- **Trust Fund exhausts all assets: 2041**

Current cost *versus* Current income in U.S. Social Security program --



Solutions to U.S. funding problem

More revenue--

- Boost payroll tax
- Infusion of new funds from Treasury
- Change investment policy to achieve higher returns
 - Inside present system?
 - In new, private accounts?

Lower pensions--

- Cut monthly pension
 - Offset with new *private* pensions?
- Delay retirement age
- Reduce COLA
- Means-test public benefits
- **Private investment accounts** instead of PAYGO public pensions

Issues in privatization

- Does U.S.A. need more advance funding?
- How should the funds be invested?
 - Which assets should be held?
 - Inside or outside the traditional system?
- Should we move to individual accounts?
- How much choice in individual accounts?
- Who should manage investments held in the retirement accounts?



1. Is more advance funding needed?

- Ultimately, funding permits lower taxes / higher future pension benefits
- However, more funding requires higher taxes / lower benefits in short term
- Increases national saving -- if not offset by higher gov't spending
- Collectively? Or in individual accounts?



2. Should we diversify the portfolio of the pension fund? ... Or hold only U.S. government bonds?

- Stocks boost returns -- and risks
- If individual accounts are offered, stock investments should certainly be an option
- If stocks are held in a GOVERNMENT trust fund, complicated governance structure is needed for investment
- Otherwise, political interference in portfolio choice might reduce returns and compromise safety

3. Move to individual accounts?

■ YES:

- Workers might accept higher contributions
- Offers workers choice
- Reduces political influence over investment decisions
- Extra contributions will yield *addition* to national saving

■ NO:

- Individual accounts will replace (not supplement) S.S.
- Worker's poor investment choices
- Low-wage workers will face high risk; may be left in lurch
- High administrative cost
- Will *reduce* total saving



The President's 2005 plan

- 1) Allow workers to divert up to 4% of wages from FICA to *voluntary* individual retirement account
 - 2) Allow investments in 5 – 7 basic investment portfolios
 - Stocks, long bonds, safe short-term bond fund, etc.
 - 3) Subtract “benefit adjustment” from standard S.S. pension when worker retires
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- 4) Restore S.S. solvency with “progressive indexation” of initial S.S. benefits

Make U.S.A. an "ownership society"

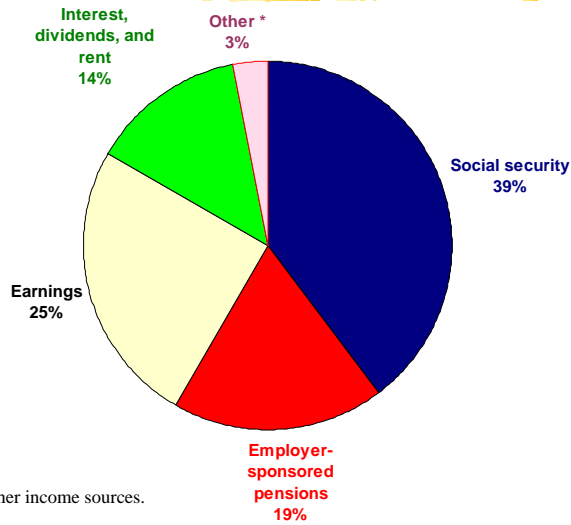
- The President's plan allows workers to build up and bequeath private wealth.
- It makes them risk takers –
 - They must decide how to allocate their savings
 - To improve on their S.S. pension, they must make more than 3% (after inflation) a year
 - They must accept risk of doing *worse* than under traditional system

U.S. is already an ownership society

- Compared with other rich countries, U.S.A. provides middle-income retirees with low Social Security replacement rates
- Americans derive much higher % of retirement income from private income sources –
 - Employer funded pension plans
 - Own retirement savings: IRA, Roth IRA, Keogh
 - Owner-occupied home

Social Security provides roughly 40% of U.S. aged population's cash income.

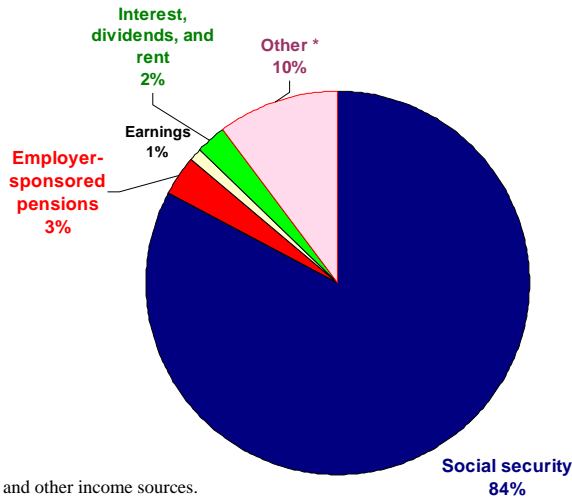
Income sources of population 65 and older, by source (2002)--



* Social assistance and other income sources.

Social Security provides a much bigger percentage of poor retirees' cash income.

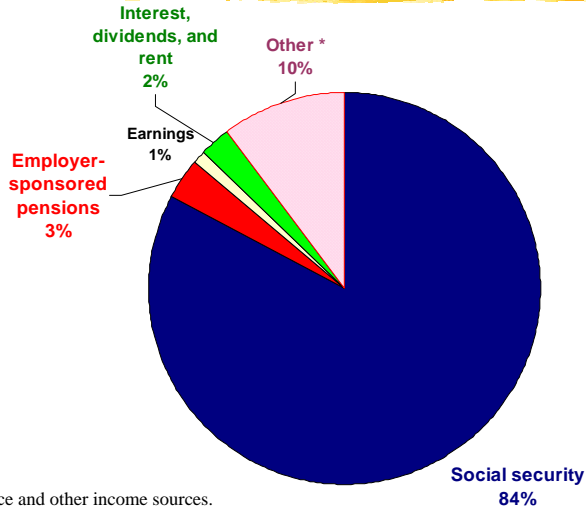
Income sources of poorest one-fifth of aged households, by source (2002)--



* Social assistance and other income sources.

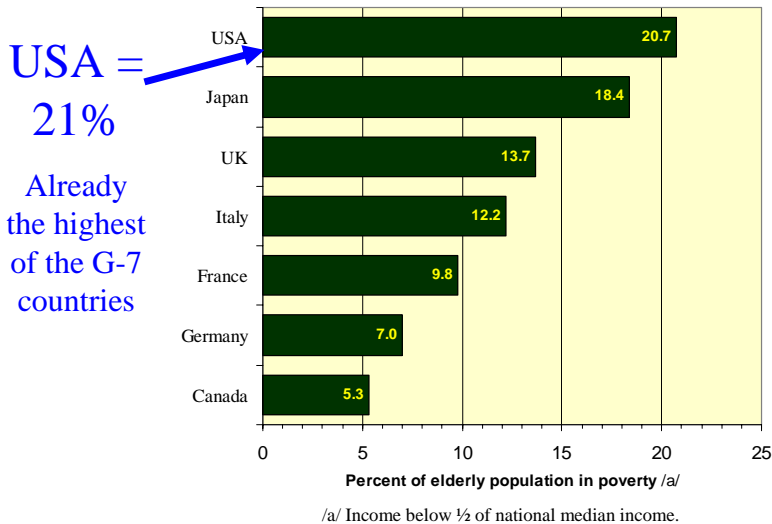
Social Security also provides a large percentage of middle-class retirees' cash income.

Income sources of middle one-fifth of aged households, by source (2002)--

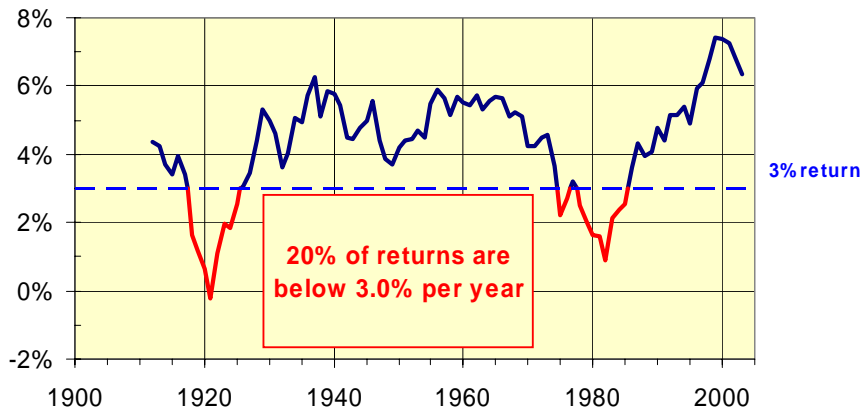


* Social assistance and other income sources.

Poverty rate among aged persons in 7 rich countries (mid-1990s)

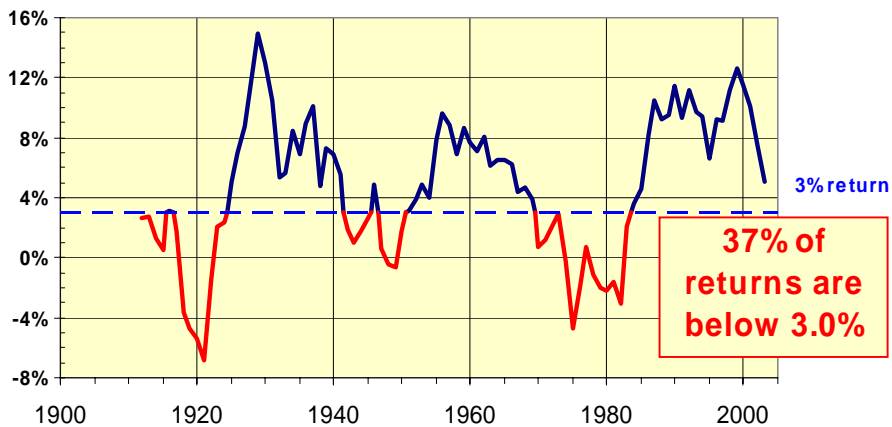


Forty-year returns on 50/50 stock-bond portfolio, 1912-2003



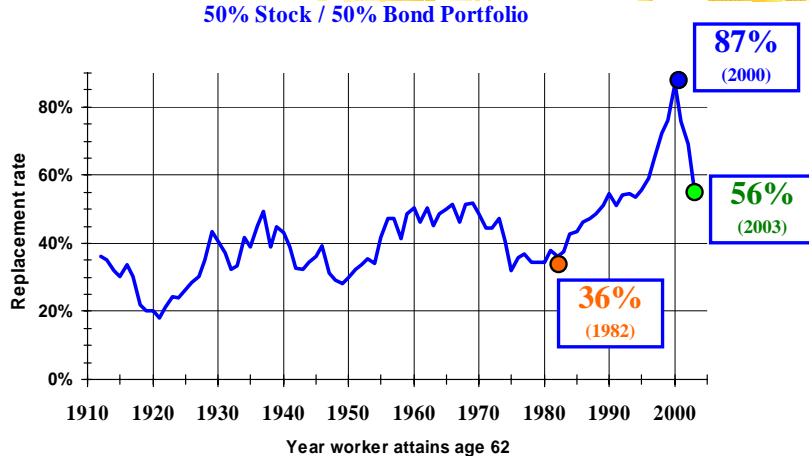
Calculations based on historical stock and bond returns, 1872 - 2003: 40-year returns

Ten-year returns on 50/50 stock-bond portfolio, 1912-2003



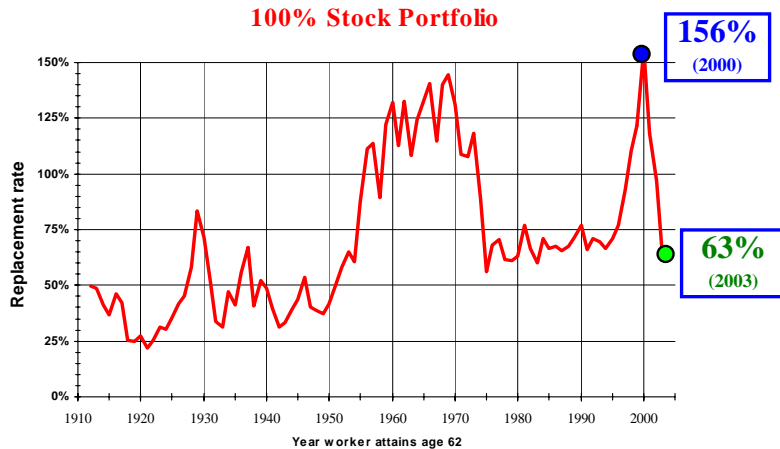
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Workers' "earnings replacement rate" after a 40-year career investing 7% of his wages in U.S. stock / bond portfolio



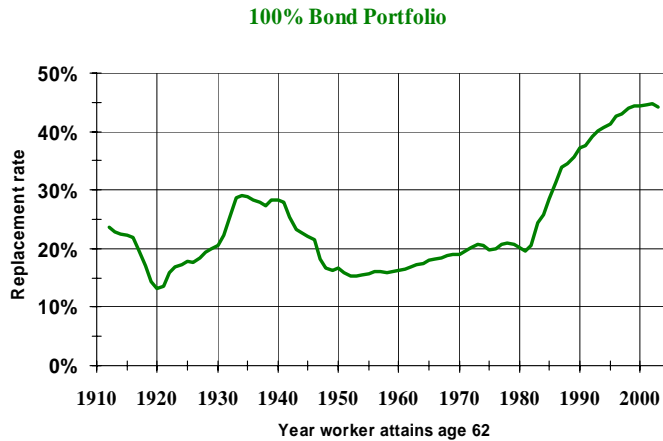
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Calculations based on historical stock and bond returns, 1872 – 2003

Conclusions

- America is already an "ownership society"
- Ownership is favored by *both* political parties
- The question is the balance between guaranteed and risky components of income in old age
- What we know about workers' investment skills: *They are limited*
- For low- and middle-income retirees, I would leave the current balance of risks *unchanged*
- The President would *increase* retirees' income risk

Conclusions

- The President's plan would almost certainly *add* to the Federal deficit
- It would *reduce* U.S. government and national saving
- In view of the outlook for an older population, U.S.A. should be *increasing* government and national saving
- The U.S. public has basically *rejected* the President's proposal for reform