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SUPPLY-SIDE CONSEQUENCES OF SOCIAL SECURITY REFORM: IMPACTS ON SAVING AND EMPLOYMENT

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Partial replacement of the traditional unfunded pension system with a new system of private investment accounts can potentially increase saving and improve incentives for labor force participation later in life. Both of these responses would lead to higher levels of future income. In this paper we investigate whether these effects are likely to occur and the potential size of the effects on private and total saving and on employment past age 55.

Policymakers can follow two approaches to pension reform that can lead to greater advance funding of future pension obligations. They can immediately increase taxes or reduce benefits in the public pension program so as to increase the accumulation of reserves held by the pension fund. Or they can establish a new system of private pension accounts in which workers build up private funds that will later be used to finance retirement benefits. An important advantage of advance funding is that it can lead to an increase in saving, faster growth in the capital stock, and higher future national income. These results will only occur, however, if the additions to pension reserves lead to an increase in public or private saving.

We evaluate the empirical evidence on government saving responsiveness to faster public pension fund accumulation. The experience of U.S. state government suggests that faster accumulation of reserves in public employee pension funds adds almost $1 of additional state government saving for each additional $1 that is added to the funds. State governments do not offset faster saving in the pension funds by running larger deficits or smaller surpluses in other state government budget accounts. The experience of national governments in the OECD is quite different. Faster accumulation of assets in national social insurance systems is largely offset by larger deficits or smaller surpluses in other national government budget accounts. If the state-level experiences could be duplicated at the U.S. federal government level, faster accumulation of saving in the Social Security Trust Funds will produce a sizeable increase in overall saving and future income. If the experiences of OECD nation states are treated as a more reliable guide to the U.S. government response to bigger Social Security surpluses, larger pension surpluses will be substantially offset by bigger deficits in other federal accounts, and there will be little net impact on aggregate saving or future national income.

We performed a similar review and analysis to assess the impact of faster fund accumulation in private pension accounts. The focus of this evaluation was on the private saving response outside of pensions to faster fund accumulation within a new or revamped private pension system. Our review and statistical analysis show that there is a very large potential for workers to offset faster accumulation in new pension accounts through reduced saving in their non-pension household saving. These empirical findings suggest that the aggregate saving response and future income gains that would follow creation of new private pension accounts will probably be small. The additions to private and aggregate saving will be much smaller than the additions to the new private pension accounts.

The evidence on labor supply responsiveness to Social Security incentives is much more extensive than that on public and private saving responses to pension fund accumulation. There is also broader agreement in the empirical literature that Social Security has had a significant depressing effect on older Americans' labor supply. However, empirical analysts do not agree on whether the response to Social Security incentives explains most or only a small part of the long-term decline in labor force participation rates at older ages. Most statistical studies based on the experiences of large samples of individual workers imply that the impact of Social Security, while statistically significant, has not been particularly large. On the other hand, the long-term decline in older Americans' participation rates coincided with a major expansion in Social Security eligibility and generosity. Cross-national analysis shows that countries with more generous or distortionary pensions and with pensions that are available at a younger age have much lower labor force participation rates among their aged populations.

To provide an upper-bound estimate of the potential impact of Social Security reform on future labor supply we estimated a simple model to explain shifts in relative labor force participation rates over the post-war period. Our model was intentionally designed to attribute all the long-term decline in U.S. old-age participation rates to long-term increases in the Social Security replacement rate and reductions in the early entitlement age for benefits. Predictions based on this model suggest that reducing Social Security benefits by a third might increase labor force participation of 55-74 year-old men by up to 15 percent. A reform which increases the eligibility age for early Social Security pensions might increase female participation in the same age group by 11 or 12 percent. Although these upper-bound responses seem large, they would add only 2-3 percent to the size of the future U.S. workforce.

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