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

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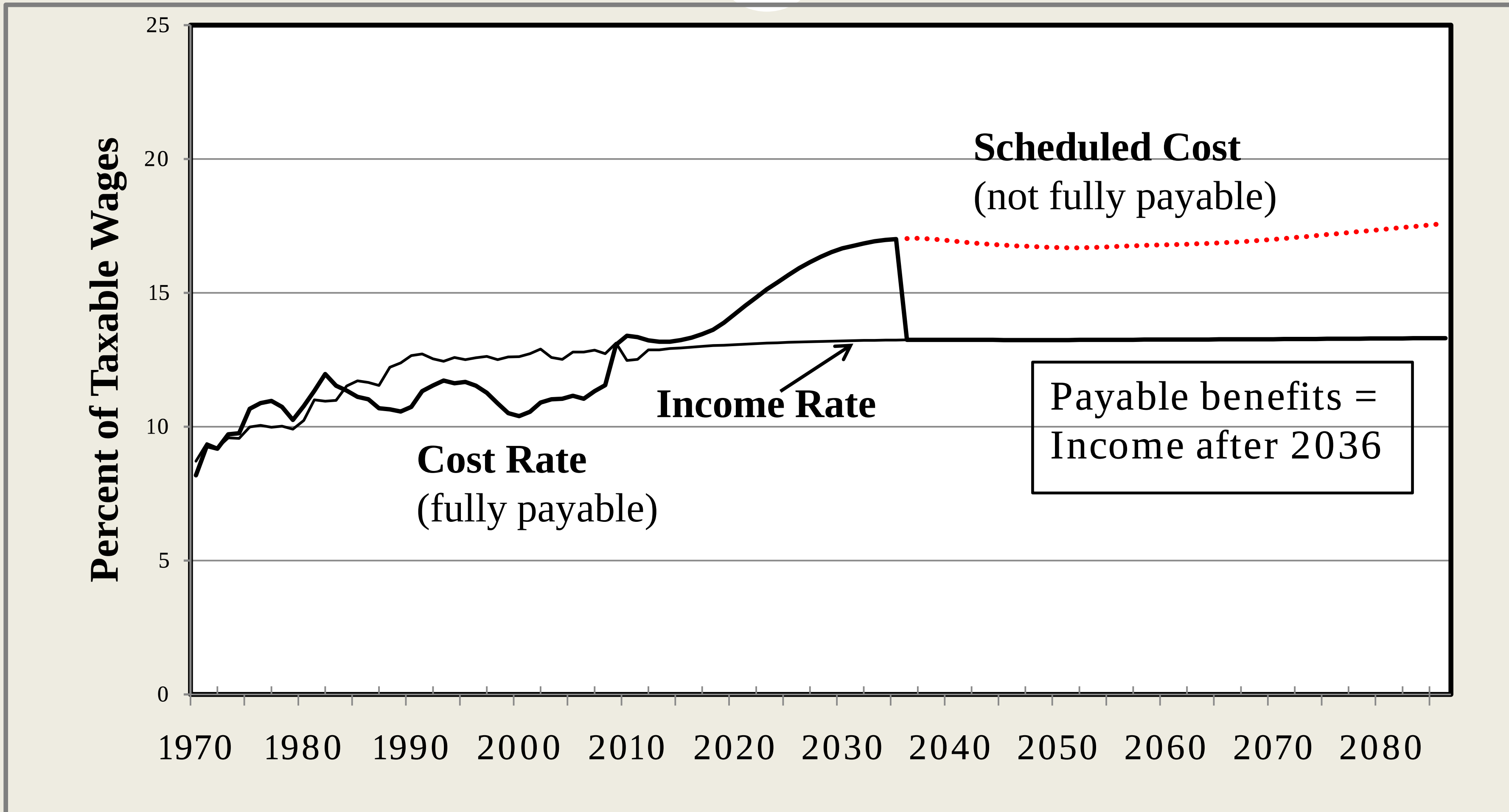
Social Security's Finances

- 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.

Automatic Stabilizer Mechanisms

- 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 Experience

- 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

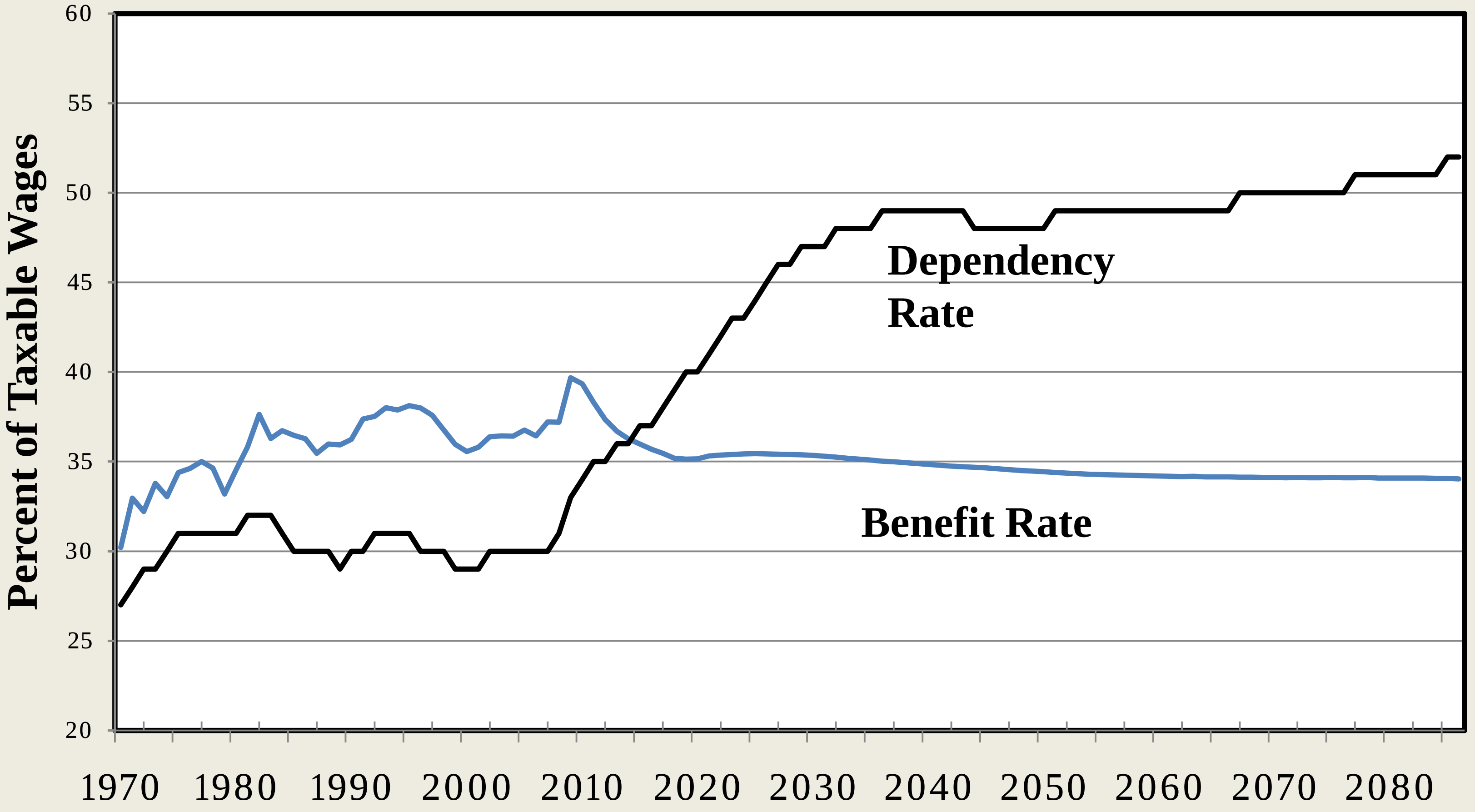
ASM Lessons for Policymakers

- 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