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Viewpoints

U.S. Should Study Swedish and German Social Security Reforms

by James C. Capretta

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In recent weeks, both U.S. President George W. Bush and new Treasury Secretary Henry Paulson have made it clear they are planning another effort to rein in future spending on the highly popular, but expensive, federal entitlement programs: Social Security, Medicare, and Medicaid.

That is good news for the country, if not for an administration already stretched by its current agenda. Projections show that, left unchecked, those three programs alone will swallow up every available tax dollar and then some.

Unfortunately, the time available for reform is running short, as the baby-boom generation is on the verge of joining the ranks of Social Security and Medicare beneficiaries in large numbers. According to the U.S. Census Bureau, in 2005, 2.2 million Americans turned 65. In 2015 the cohort of new 65-year-olds will be more than 50 percent larger — at 3.4 million. And in 2025 the number of people turning 65 will be 4.2 million. The population aged 65 and older will nearly double in 25 years, from 37 million in 2005 to 70 million in 2030.

The unprecedented aging of the U.S. population will put tremendous pressure on the federal budget. According to the Congressional Budget Office, between 2010 and 2030, spending on the big three entitlements will go from 9.2 percent to 15.2 percent of gross domestic product using intermediate assumptions — a 6 percentage point increase in just 20 years.

Bush's attempt in 2005 to start the entitlement reform process with Social Security showed just how steep the hill is for would-be reformers. It is no accident that Social Security hasn't changed in any significant way in more than two decades. With no imminent crisis, U.S. politicians have found it relatively easy to delay the tough decisions on entitlements even as the budget crunch draws near.

That's not the case for most of Europe's state pension programs. With plummeting birth rates, rapidly aging populations, and expensive benefit formulas, governments throughout Europe have been forced to act — some more decisively than others — to head off the financial train wrecks that were, and in some cases still are, already upon them.

Usually, U.S. policymakers look to Europe to determine what *not* to do when it comes to social welfare policy. And, in fact, most of Europe remains in a deeper hole than the United States in terms of the long-term fiscal implications of population aging, as their state pension programs remain far too expensive, even after implementation of some far-reaching reforms. Nonetheless, as the saying goes, when you are in a hole, the prudent first step is to stop digging, and the United States can indeed gain insight into how to "stop digging" the entitlement hole by studying the reforms some of their

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European counterparts implemented to cut their long-term pension commitments.

In particular, Swedish and German pension reforms deserve careful attention.

In the 1990s, facing steep tax hikes necessary to preserve the status quo, Sweden adopted a radical new approach to pension financing. The multiparty coalition embracing reform chose to design the new pension system within a budget — fixed at 16 percent of covered wages. To hit that target, Sweden changed the pension entitlement from a defined benefit to a "notional defined contribution." Workers' payroll tax contributions are treated like contributions into an investment fund even though the actual tax payments are used to finance benefits for current retirees. The contributions are tracked separately and credited with a default "rate of return" equal to growth in average wages in the economy.

To keep actual pension payouts within available revenue, Sweden has incorporated two self-adjusting features into the notional accounts.

First, the account balances are converted into benefits by way of an annuity divisor — effectively dividing the notional account balance into monthly benefits over the expected life span of the retiree. Importantly, the divisor is updated each year to stay current with measured advances in longevity. So, as retirees live longer, the monthly annuity paid out from a fixed notional balance will automatically decline with successive cohorts unless the pensioners choose to begin taking their benefits later in life than those who retired before them. An increase in the "retirement age" for benefit eligibility brings important economic benefits that the annuity divisor lacks — such as stronger incentives for continued work. Nonetheless, with the annuity divisor, Sweden no longer has to worry about adjusting benefits to offset the added costs of increased longevity — it happens automatically.

Second, Sweden adopted an "automatic balance mechanism." Each year, the government determines how much interest earnings can be applied to the notional balances without exceeding available payroll tax revenue. The critical demographic and economic factors — such as the size of the workforce, total payroll tax payments, and the age of workers relative to pensioners — are then combined into a summary measure of the system's "assets." If assets fall below projected liabilities, the default rate of return earned in the notional accounts is automatically cut to keep the system in balance. If, for instance, fertility continues to trend downward, the average age of workers will eventually creep upward, reducing the value of the system's measured "assets," which will, in turn, force a lower return on the notional balances.

The government projects that updating the annuity divisor annually will cut average monthly benefits for those continuing to retire at age 65 by 14 percent by 2055 — which is equivalent to a delay in their retirement of 26 months. It also projects that the automatic balance mechanism will be triggered only a few times in coming years. Under more pessimistic assumptions, however, the automatic balance mechanism would be triggered more or less continuously beginning in 2008, automatically driving down the replacement rates for retirees for several decades. Either way, however, the system would remain financially solvent at the 16 percent payroll tax rate.

Germany has been less aggressive than Sweden, and the system remains far too expensive. Nonetheless, in 2004 the government took an important step by establishing a link between annual pension indexing and changes over time in the ratio of pensioners to workers supporting the system — the so-called sustainability factor. All German pensions — for new retirees and those who retired in earlier years — are tied to the same basic pension value component, which in turn is indexed to annual wage growth. Adjusting the pension value component by the sustainability factor will have a powerful stabilizing effect on the pension system because it will lower pension payouts for all German retirees as the pensioner-to-worker ratio increases over time. The sustainability factor is expected to cut the necessary payroll tax by 4 percentage points in 2040, from 28 percent of wages to just under 24 percent.

U.S. policymakers should look to build similar automatic adjustment mechanisms into Social Security. For instance, the age at which full benefits are paid should be automatically adjusted to reflect ongoing improvements in average life spans. When Social Security began, men retiring at 65 could expect to get benefits for 12 years. Today, a male retiree at 65 will get benefits for 16 years, and further improvements in longevity are expected in the years ahead. It should be obvious that ever longer periods of retirement will eventually become unaffordable (without more robust population growth), and automatic adjustment provision for the full benefit retirement age is a simple recognition of that fact.

The United States should also consider building into initial benefit payments a German-style sustainability factor. As the ratio of beneficiaries to workers increases, a new "dependency ratio" factor could be applied to the benefit formula, effectively reducing benefits payable to new retirees to keep them in line with the level that can be supported with the current payroll tax rate. Once in payment status, beneficiaries would get full inflation protection with annual cost-of-living increases.

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Building automatic adjustment mechanisms into Social Security has important advantages over more direct benefit cuts and tax increases. First, if current projections are wrong — as they inevitably will be — the automatic provisions are self-correcting. That should be attractive to both optimists and pessimists. Second, it may be easier for Congress to pass mechanistic provisions with more uncertain implications for future benefits than changes that more clearly and directly cut benefits.

No one should be under the illusion, however, that any version of Social Security reform will be easy to pass. But it is almost certain that a reform will pass — eventually. The disruptions caused by the status quo will become unbearable at some point. When that time comes, the United States could steal a page from the Europeans who have been there. ◆

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