

## Reforming American Pensions: The Route to Real Pensions Reform

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OP-ED CONTRIBUTOR

Progressive indexing of retirement benefits by wage level, argues **Robert Pozen**, is the key to Social Security reform

UNDER the slogan of reforming Social Security, America's state pension system, George Bush wants to allow workers to allocate a modest portion of their Social Security taxes to a personal retirement account. Some Republicans want to do this without enacting broader reforms to the state pension system. The result, as *The Economist* discussed on this page on December 11th, would be a sharp increase in short-term federal borrowing without any decrease in the system's huge long-term deficit. Some Democratic opponents of personal retirement accounts advocate a complex combination of tax increases and benefit reductions to eliminate Social Security's financial hole. But the current Congress is not likely to increase taxes, or enact reform legislation containing only the political "pain" of benefit reductions.

In a viable legislative package, personal retirement accounts supply the political sweetener that allows the passage of benefit reform, which reduces Social Security's long-term deficit. That leaves a crucial question: What type of benefit reform?

One logical answer would be to increase the normal retirement age since Americans, on average, will draw Social Security benefits for more years. The normal retirement age is already slated to rise to 66 by 2011 and to 67 by 2027. It could be extended gradually to 70 by 2057. But such an extension would face three practical challenges. First, many senior citizens already have difficulties finding full-time employment. Second, most elderly Americans want to retire earlier rather than later. Third, low-wage workers tend to hold jobs requiring a relatively high degree of physical labour, so they may be physically incapable of working in the jobs available to them over age 67.

A second answer would be to move completely from wage to price indexing in calculating initial Social Security benefits. Price indexing means increasing retirement benefits in line with consumer prices, in order to protect the purchasing power of such benefits. Wage indexing means increasing retirement benefits in line with wages, in order to preserve the portion of wages replaced by benefits. After retirement, Social Security benefits are already indexed to prices through annual cost-of-living adjustments. But at the time of retirement, workers' initial benefits are set by adjusting their average career earnings upwards by average wage growth over their careers.

It was reported this week that the White House is likely to propose a shift from wage to price indexing of initial benefits. Using wage indexing instead of price indexing in computing initial benefits has a tremendous financial impact on Social Security, since wages have, on average, risen more than a percentage point per year faster than prices. If Congress today

switched from wage to price indexing of initial benefits, this alone would eliminate the 75-year deficit of Social Security. So why don't we make the switch? Because it would have a devastating impact on low-wage earners who depend almost entirely on Social Security for retirement income.

The third and best answer is progressive indexing. This means the continuation of wage indexing for all workers with average career earnings of \$25,000 or less. It also means not touching the benefit formulas of anyone already in or near retirement (workers aged over 55 today). Conversely, the initial benefits of all workers with average career earnings above \$113,000 retiring after 2011 would be increased by price indexing. Almost all these workers receive significant amounts of retirement income from company plans and other savings vehicles in addition to Social Security. The initial benefits of workers falling between these two groups would be increased by a proportional blend of wage and price indexing.

While the Social Security benefits of most middle and high earners would still rise under progressive indexing, they would grow more slowly than under the current system. To make this package politically attractive, Congress should offer all workers the chance to offset most of this slower growth in traditional benefits by allowing them to invest two percentage points out of the 12.4% in payroll taxes they pay on all wages up to an annual maximum (\$90,000 in 2005 and rising yearly). This money would be invested in a standard balanced account, with 60% of assets in a broad-based American stock index, such as the Wilshire 5000, and 40% in a high-quality bond index, such as the Lehman Aggregate Bond index.

According to the chief actuary of Social Security, the standard balanced investment account is expected to produce an annual real return averaging over 4.9% per year after expenses—significantly higher than the returns in the current system or from Treasury bonds. Participating workers would receive retirement income from their personal accounts as well as traditional Social Security benefits. Accordingly, the traditional benefits of these workers would be lowered by the total amounts allocated to their accounts plus interest.

This combination of progressive indexing and balanced accounts would cut the long-term deficit of Social Security by half, from a present value of \$3.8 trillion to \$1.9 trillion over the next 75 years. Of course, the transition from the current system to this combination would require some federal borrowing before the system's economics are reversed. But under reasonable estimates of participation in investment accounts, all borrowing would be completed by the end of the 75-year period. At that time, the Social Security system would be in financial balance and would be self-sustaining.

The time for this type of reform is running out. After the baby-boomers start to retire in 2011, their benefit formulas will in effect be locked in—politically it is virtually impossible to change these formulas for those in or near retirement. Thus, to fix the long-term finances of Social Security, Congress has a one-time opportunity to link personal retirement accounts with benefit reform through the introduction of progressive indexing. That opportunity should not be missed.

By invitation

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