

Lessons from Abroad for the U.S. Entitlement Debate

Author

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CSIS | CENTER FOR STRATEGIC &
INTERNATIONAL STUDIES



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INTRODUCTION

FROM THE CONGRESSIONAL BUDGET OFFICE AND THE GOVERNMENT ACCOUNTABILITY OFFICE TO THE BOWLES-SIMPSON AND DOMENICI-RIVLIN COMMISSIONS, everyone who has looked seriously at the fiscal arithmetic agrees that there is no solution to America's long-term budget problem that does not include fundamental entitlement reform. After all, federal entitlement programs make up well over half of federal spending today and account for all projected growth in noninterest outlays as a share of GDP over the next three decades.

Demographers, economists, and policy experts have been warning for decades that the aging of America would eventually trigger an explosive rise in entitlement spending that pushes the federal budget toward a fiscal precipice. Two recent developments, however, have now greatly increased the urgency of reform. The first is the retirement of the baby boom. With the leading edge of this outsized generation reaching old age, the long-predicted cost spiral in retirement and health-benefit programs is finally upon us. The second is the economic and financial crisis, which has driven the federal debt to unprecedented peacetime highs and obliterated much of the fiscal room the United States may have had to accommodate the projected growth in entitlement spending. Together, these developments have transformed America's long-term budget problem into a near-term problem as well.

As the United States grapples with entitlement reform, it has much to learn from the experience of other countries. The United States, after all, is not the only developed country that is aging. Nor is it the only developed country whose coming age wave poses politically difficult trade-offs between protecting current benefit promises to the old and imposing a rising tax burden on the young. In fact, those trade-offs may be even more difficult in other countries, since most are due to age more than the United States and most have more generous welfare states and higher levels of elderly dependence on government benefits.

Yet surprisingly, many developed countries have moved much more deliberately than the United States has to reduce the long-term fiscal cost of their age waves. Several have enacted sweeping overhauls of their public pension systems designed to stabilize their cost as a share of GDP. Italy and Sweden are transforming their traditional defined benefit pension systems into notional defined contribution systems in which benefits are in effect indexed to the growth in the payroll tax base. Germany and Japan have introduced "demographic stabilizers" into their pension systems that

achieve a similar result by automatically adjusting annual benefit payments to partially or fully offset the annual change in the dependency ratio of retired beneficiaries to contributing workers. In many more countries, recent reforms have trimmed benefit formulas, raised retirement ages, and put in place new funded pension systems that supplement or partially substitute for pay-as-you-go systems. Meanwhile, on the health-benefit side, most developed countries have been more successful than the United States at imposing budget constraints that control—or at least moderate—the rate of spending growth.

Although these reforms have been the subject of much academic research by U.S. scholars,¹ they have yet to capture the attention of the broader U.S. policy community. The lack of knowledge about reform developments in other countries is unfortunate, since they offer important practical lessons not just for how to control the long-term growth in entitlement spending, but also, more broadly, for how to prepare America's overall economy and society for the demographic gauntlet that lies ahead.

The current report helps to fill this gap by examining the most promising reform strategies being pursued in nine other developed countries: Australia, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, and the UK. The focus of the report is on retirement programs and retirement policy. It is sometimes argued that achieving savings in Social Security is unimportant or even unnecessary, since most of the projected growth in the overall U.S. old-age dependency burden is due to growth in Medicare and Medicaid. While it is true that achieving savings in health-benefit programs must be a high priority, it does not follow that retirement reform can be neglected. Federal cash benefits to the elderly account for a large and rising share of total federal outlays.

Moreover, there is no guarantee that health-care cost control efforts will be effective. Indeed, if the history of past efforts is any guide, it is likely that advances in medical technology and rising public expectations about care and cure will interact with demographic aging to put relentless pressure on the federal budget for decades to come. To the extent that health-benefit spending proves difficult to control, reducing retirement spending becomes all the more important. From the viewpoint of the budget and the economy, what matters is the total resource burden of federal entitlement programs, not which federal agency is dispensing the benefits.

In addition to discussing retirement reform developments in other countries, the report examines how well different countries are balancing the twin policy goals of fiscal sustainability and income adequacy. Here the report draws on CSIS' Global Aging Preparedness Index (or GAP Index), which provides a consistent set of quantitative measures of the progress that countries worldwide are making in preparing for global aging, and particularly the old-age dependency dimension of the challenge.² All projections of public old-age benefit spending, as well as all data on elderly income and elderly poverty rates, come from the GAP Index.

By drawing attention to the progress that other developed countries are making in meeting their aging challenges, it is the author's hope that this report will help to advance the U.S. debate over entitlement reform. The first chapter puts the U.S. aging challenge in international perspective, while along the way highlighting some of America's relative strengths and weaknesses. The second chapter offers brief reform profiles for each of the nine other countries covered in the report. The third and final chapter draws some broad lessons for U.S. policymakers. ►

1. See, for instance, Martin Neil Bailey and Jacob Funk Kirkegaard, *U.S. Pension Reform: Lessons from Other Countries* (Washington, DC: Peterson Institute for International Economics, 2009); Barry Bosworth and R. Kent Weaver, "Social Security on Auto-Pilot: International Experience with Automatic Stabilizer Mechanisms," CRR Working Paper no. 2011-18 (Boston: Center for Retirement Research at Boston College, November 2011); and Rudolph G. Penner, ed., *International Perspectives on Social Security Reform* (Washington, DC: Urban Institute, 2007).

2. Richard Jackson, Neil Howe, and Tobias Peter, *The Global Aging Preparedness Index, Second Edition* (Washington, DC: Center for Strategic and International Studies, 2013).

CHAPTER ONE

The U.S. Aging Challenge in International Perspective

THE WORLD IS BEING OVERTAKEN BY A STUNNING DEMOGRAPHIC TRANSFORMATION BROUGHT ABOUT BY DECLINING FERTILITY AND RISING LIFE EXPECTANCY. It is called global aging, and it promises to affect virtually every dimension of economic and social life over the next few decades, from the shape of the family to the shape of the geopolitical order.

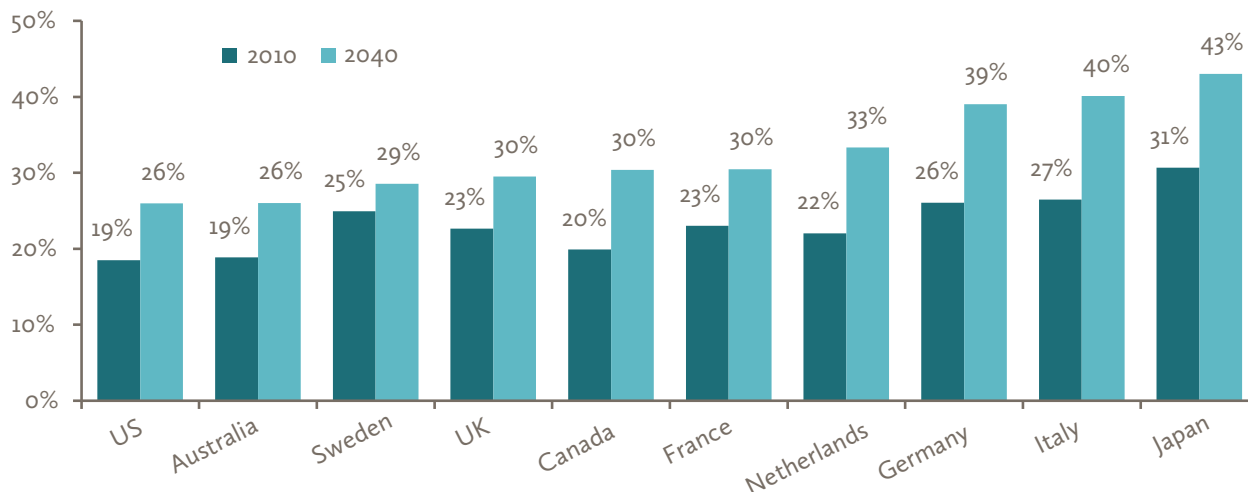
For most of history, the elderly—defined throughout this report as adults aged 60 and over—comprised only a tiny fraction of the population, never more than 5 percent in any country until well into the Industrial Revolution of the nineteenth century. In the developed world today, the elderly comprise a little over 20 percent of the population. By 2040, the share will reach 30 percent, and this is just the average. In Japan and some fast-aging European countries, it could be approaching or even passing 40 percent.³

In recent years, global aging has become the focus of growing concern throughout the developed world. Much of this concern has centered on the rising fiscal burden that government old-age benefits threaten to impose on future workers and taxpayers. Most developed countries have universal pay-as-you-go public pension systems that were put in place in the early postwar era when workers were abundant and retirees were scarce, but which are now being rendered unsustainable by the rapid aging of their populations. Graying also means paying more for health care, because the elderly in most countries consume at least three times more per capita in medical services than the nonelderly and at least ten times more in long-term care services.

In some respects, the United States is well positioned to confront the global aging challenge. Although the United States is aging, it is now the youngest of the major developed countries and, thanks to its relatively high fertility rate and substantial net immigration, it is projected to remain the youngest for the foreseeable future. The share of the U.S. population aged 60 and over, now 19

3. With the exception of historical data on U.S. fertility rates, which come from the U.S. Census Bureau, all demographic data cited in the report come from *World Population Prospects: The 2012 Revision* (New York: UN Population Division, 2013). Population projections refer to the UN's "constant fertility variant" projection. For a discussion of the UN projections, as well as the other data sources used in the report, see the Technical Note on Data and Sources.

FIGURE 1: PERCENT OF THE POPULATION AGED 60 & OVER IN 2010 AND 2040



Source: World Population Prospects: 2012 Revision (New York: UN Population Division, 2013)

percent, will increase to 26 percent by 2040, compared with 30 percent in France, 39 percent in Germany, and 43 percent in Japan. (See figure 1.) Meanwhile, the U.S. median age will rise from 37 to 40, while Europe’s will rise from 40 to 48 and Japan’s from 45 to 55. By the 2020s and 2030s, the United States will also be one of the few developed countries whose working-age population will still be growing.

Over the past few years, there has been some concern that the United States may be losing what Nicolas Eberstadt calls its “demographic exceptionalism.”⁴ From the late 1980s through the beginning of the Great Recession in 2008, the U.S. fertility rate hovered between 2.0 and 2.1, close to the so-called replacement rate. Just three other developed countries—Iceland, Ireland, and New Zealand—have consistently had fertility rates this high. By 2011, however, the U.S. fertility rate had slipped to 1.9, the lowest level in twenty-five years. Meanwhile, net immigration has also fallen sharply. Although these developments are worrisome, they should not be a cause for alarm. It is too soon to tell whether the recent declines in fertility and immigration will prove lasting. And even

if they do, the United States would still enjoy a considerable demographic advantage over almost every other developed country.

Most other developed countries are not only due to age more than the United States is, but also have more expansive welfare states and more expensive old-age benefit systems. The U.S. cost advantage in public pensions is especially striking. According to CSIS GAP Index projections of old-age benefit spending, seven of the other nine countries covered in the report will be spending a larger share of their GDPs on public pensions in 2040 than the United States will, and three of them—France, Germany, and Italy—will be spending twice as much. Only Australia and Canada will be spending less. (See table 1.) To be sure, Social Security, which accounts for the lion’s share of U.S. public pension spending, is seriously underfunded, with dedicated tax revenues projected to cover just 78 percent of benefits by 2040.⁵ Nonetheless, the overall cost of the program is modest by developed-world standards. If we instead look at total government benefits to the elderly, including health benefits, the U.S. cost advantage narrows significantly. Yet at 18.5 percent of GDP

4. Nicolas Eberstadt, “Demographic Exceptionalism in the United States: Tendencies and Implications,” *Agir* 29 (January 2007).

5. *The 2013 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Washington, DC: Social Security Office of the Chief Actuary, 2013).

TABLE 1: TOTAL PUBLIC BENEFITS TO THE ELDERLY AS A PERCENT OF GDP IN 2010 AND 2040

	PUBLIC PENSIONS		HEALTH BENEFITS		OTHER BENEFITS		TOTAL BENEFITS	
	2010	2040	2010	2040	2010	2040	2010	2040
Australia	3.7%	4.7%	3.0%	5.5%	2.3%	3.1%	9.1%	13.4%
Canada	4.0%	5.4%	4.3%	9.0%	1.0%	1.4%	9.3%	15.8%
France	12.6%	13.6%	4.7%	9.0%	1.3%	1.7%	18.6%	24.3%
Germany	10.3%	12.4%	4.7%	8.9%	1.9%	3.0%	17.0%	24.3%
Italy	13.9%	15.0%	3.9%	7.9%	2.2%	2.7%	20.0%	25.7%
Japan	9.3%	10.5%	5.2%	9.8%	0.6%	0.6%	15.1%	20.9%
Netherlands	4.6%	8.6%	3.4%	8.3%	2.2%	2.9%	10.2%	19.8%
Sweden	7.5%	8.4%	5.2%	7.3%	2.6%	3.5%	15.2%	19.3%
UK	7.5%	7.9%	4.6%	8.7%	1.9%	2.3%	13.9%	18.9%
US	4.8%	6.4%	5.1%	11.0%	1.2%	1.1%	11.1%	18.5%

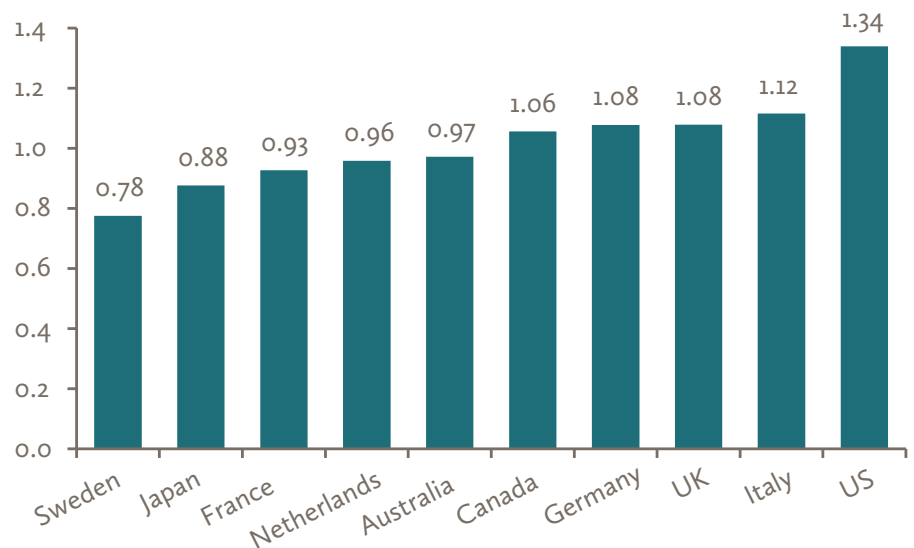
Source: The Global Aging Preparedness Index, Second Edition (Washington, DC: Center for Strategic and International Studies, 2013)

in 2040, the total U.S. public old-age dependency burden is still projected to be lower than that of any of the other countries covered in the report except, once again, Australia and Canada. In Japan, the burden is projected to climb to 20.9 percent of GDP, in France and Germany to 24.3 percent of GDP, and in Italy to 25.7 percent of GDP.

One might suppose that America’s relatively less generous old-age benefits would translate into a relatively lower living standard for the elderly. But in fact, the income of the U.S. elderly compares quite favorably with that of the nonelderly. In 2010, the ratio of median after-tax elderly to nonelderly income was 1.3 to 1 in the United States—higher than in any of the other nine countries. (See figure 2.) To be sure, this does not mean that all of America’s elderly are well off. Compared with most European countries, the United States has both a higher level of income inequality and a less robust safety net. The share of the U.S. elderly with an income of less than 50 percent of the median income for all persons—a standard threshold in international poverty rate comparisons—was 18 percent in 2010, higher than in any of the other nine countries except Australia and Japan. Still, despite America’s less expansive welfare state, the living standard of the typical elder is surprisingly high.

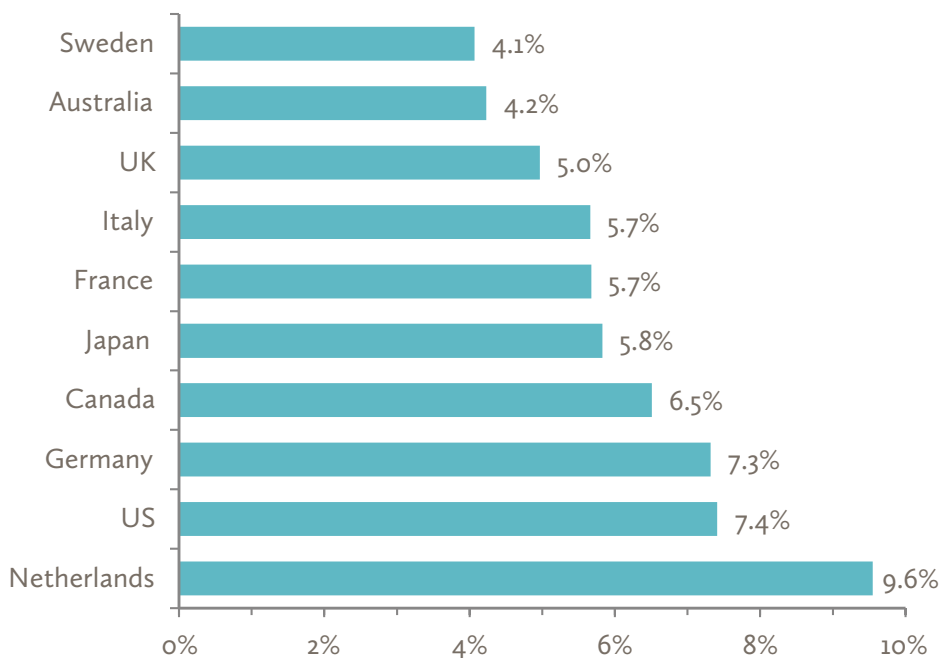
This apparent paradox is explained by the fact that a large share of the U.S. elderly have alternative sources of

FIGURE 2: PER CAPITA RATIO OF MEDIAN AFTER-TAX ELDERLY TO NONELDERLY CASH INCOME IN 2010*



*Income refers to the third quintile of the elderly and nonelderly income distribution.
Source: The Global Aging Preparedness Index, Second Edition

FIGURE 3: GROWTH IN TOTAL PUBLIC BENEFITS TO THE ELDERLY AS A PERCENT OF GDP FROM 2010 TO 2040



Source: The Global Aging Preparedness Index, Second Edition

income support. There is America’s funded pension system, which, despite large gaps in coverage, helps to lift elderly living standards while taking pressure off of public budgets. All told, funded pension benefits, including both benefits from employer plans and personal pensions like IRAs, make up roughly 30 percent of the income of the median-income elderly in the United States, a larger share than in any of the other nine countries except Canada. In the large economies of continental Europe, funded pension benefits constitute a trivial share of elderly income: 5 percent in Germany and Italy and just 1 percent in France. Then there is employment income. The U.S. elderly labor-force participation rate exceeds that of all of the other nine countries except Japan. In 2010, 39 percent of U.S. adults aged 60–74 were in the labor force, twice the participation rate for that age group in Germany and four times the participation rate in France and Italy.

Yet despite its many advantages, the United States faces an aging challenge that may be every bit as daunting as those facing countries

with far larger age waves and much more expansive welfare states. Although the projected level of U.S. spending on old-age benefits is not especially high, the projected growth in old-age benefits is. In fact, with the single exception of the Netherlands, that growth—7.4 percent of GDP from 2010 to 2040—is greater than the growth projected for any of the other nine countries. (See figure 3.)

While the level of old-age

benefit spending is clearly the most direct measure of the resource burden of population aging, the growth in that spending may be just as important. After all, some societies may be institutionally and culturally better equipped to manage rising old-age dependency costs than others. From this perspective, the road ahead for the United States, with its tradition of limited government, may be just as bumpy as for some countries that are projected to spend much more on the elderly.

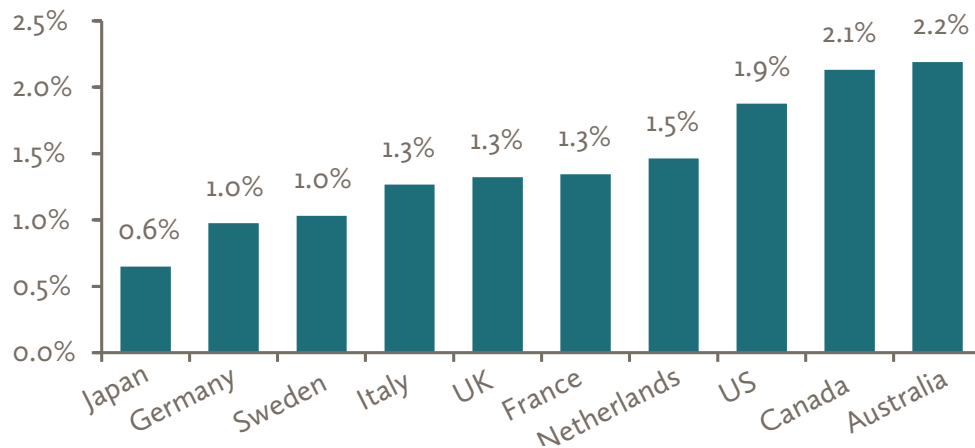
The unusually rapid ramp up in U.S. old-age benefit spending is in part attributable to America’s unusually large baby boom. Although the United States is due to age less than most developed countries, the upward shift in its age structure will occur very rapidly. As the baby boom has moved through youth and middle age, it has temporarily slowed the aging of the U.S. population. But now, with its leading edge arriving in old age, the baby boom is accelerating it. Between 2010 and 2040, the number of Americans aged 60 and over will grow at the average annual rate of 1.9 percent—faster than in any of the other nine countries except Australia and Canada, which also had unusually large baby booms. (See figure 4.) According to the Congressional Budget Office, the resulting surge in the number of beneficiaries, together with rising life expectancy, will account for all of the

growth in Social Security retirement benefits and over half of the combined growth in spending on Social Security and the major health-benefit entitlements over the next twenty-five years.⁶

The fiscal shock of the baby boom’s retirement will be amplified by the exceptionally rapid rate of growth in U.S. health-care costs. Over the twenty-five years from 1985 to 2010, real age-adjusted public health-care spending per capita has grown at the average annual rate of 4.1 percent in the United States. In none of the other nine countries did this growth rate exceed 3.0 percent, and in Canada, Germany, Italy, and Sweden it was less than 2.0 percent. Although many factors have contributed to more rapid U.S. cost growth, including higher U.S. administrative costs, the greater fragmentation of the payer side of the U.S. market, and the worse health profile of the U.S. population, the most critical factor has been the lack of any effective budget constraint designed to force cost-benefit trade-offs at either the macro or the clinical level. There is some evidence that the ability of governments in other countries to impose limits on the price and volume of health-care services may be weakening as public expectations of the health system rise. Meanwhile, U.S. cost growth has slowed dramatically over the past few years. Although it is too soon to tell whether these developments will be lasting, they may point to an eventual long-term convergence in growth rates across countries. Still, most projections, including the CSIS GAP Index projections used in this report, assume that U.S. costs will continue to rise more rapidly than costs in other countries.

The greater success of other developed countries at limiting the growth in health benefits is well known. What is less appreciated is that many of these same countries have also been more successful at limiting the growth in retirement benefits. Faced with projections showing that population aging would put relentless upward pressure on public pension spending, a growing number of governments have enacted fundamental reforms that reduce the future generosity of state retirement provision. In some countries, the reductions are very large. Compared with a hypothetical “current-deal” scenario in which today’s average replacement rates and retirement ages remain unchanged, the total cost of current-law public pension benefits in the United States is due to be cut by roughly one-fifth by 2040, a reduction mainly attributable to the scheduled increase in Social Security’s normal retirement age and to the gradual replacement of the old CSRS civil service retirement system with the new and considerably less generous

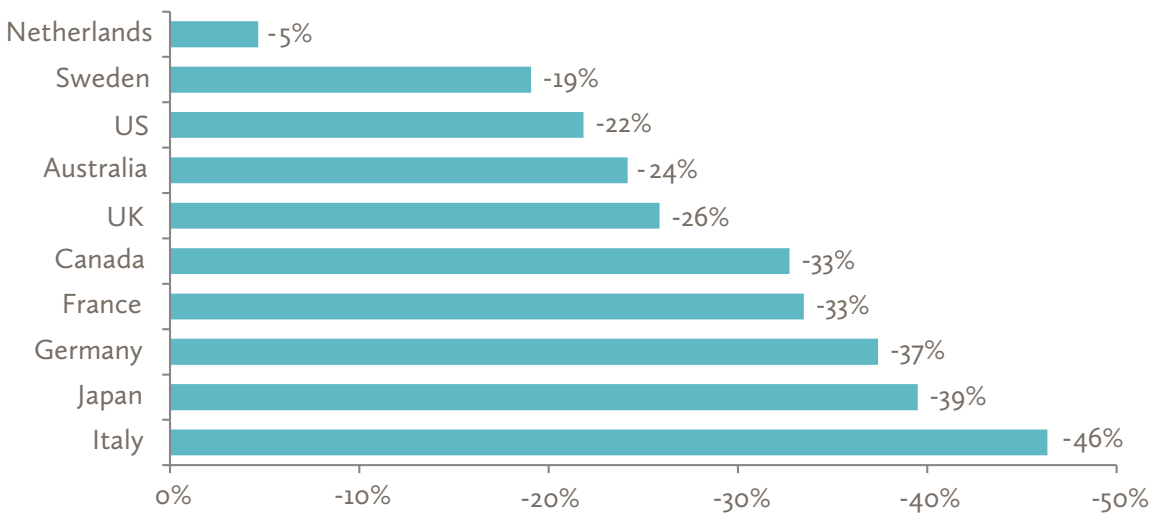
FIGURE 4: AVERAGE ANNUAL GROWTH RATE IN THE POPULATION AGED 60 & OVER FROM 2010 TO 2040



Source: World Population Prospects: 2012 Revision

6. *The 2013 Long-Term Budget Outlook* (Washington, DC: Congressional Budget Office, September 2013).

FIGURE 5: CUMULATIVE PERCENTAGE DECLINE FROM 2010 TO 2040 IN CURRENT-LAW PUBLIC PENSION BENEFITS TO THE ELDERLY RELATIVE TO “CURRENT-DEAL” BENEFITS*



*The “current-deal” projection assumes that retirement ages and replacement rates remain unchanged in the future.

Source: The Global Aging Preparedness Index, Second Edition and author’s calculations

FERS system. Meanwhile, current-law public pension benefits in Canada and France are due to be cut by roughly one-third beneath current-deal levels by 2040. In Germany and Japan, they are due to be cut by roughly two-fifths and in Italy they are due to be cut by nearly one-half. (See figure 5.)

The fact that so many countries have succeeded in passing reforms that dramatically reduce the long-term cost of their age waves points to what may be America’s greatest handicap: the difficulty the U.S. political system has in making meaningful resource trade-offs between competing priorities.

This difficulty might be less worrisome if the United States had the fiscal room to leave old-age entitlements on a rising autopilot. Unfortunately, this is not the case. While it is true that the U.S. tax burden is relatively low by developed-world standards, potential revenue increases that might have been used to finance rising old-age benefit spending have been largely precommitted to stabilizing or reducing the massive U.S. public debt, which, as of 2013, was larger as a share of GDP than that of any other developed country except Cyprus, Greece, Ireland, Italy,

Japan, Portugal, and Singapore. Meanwhile, with discretionary spending plumbing postwar lows as a share of GDP, cannibalizing the rest of the budget is no longer a viable option. A country like Sweden, with its large public sector and slowly growing old-age dependency burden, may be able to carve out a lot of extra budget space for old-age benefits, since presumably there is a lot of lower-priority spending that could be cut without much cost to society. But a country like the United States, with its small public sector and rapidly growing old-age dependency burden, may be able to accommodate relatively little growth in old-age benefits without crowding out vital public services.

The December 2013 budget deal, although it did next-to-nothing to address America’s long-term aging challenge, at least indicates a renewed capacity for bipartisan cooperation. What remains to be seen is whether that cooperation will take the form of bipartisan delay, denial, and diversion or of bipartisan willingness to seriously engage what is shaping up to be the defining challenge of the twenty-first century. The author hopes that it is the latter—and that, as America’s leaders weigh different reform strategies, they take the time to consider the many lessons that can be learned from the experience of other countries. ►

CHAPTER TWO

Profiles in Reform

THE NINE FOREIGN COUNTRIES COVERED IN THIS REPORT ARE QUITE DIVERSE IN THEIR DEMOGRAPHIC OUTLOOK, THE GENEROSITY OF THEIR PUBLIC PENSION SYSTEMS, AND THE AVAILABILITY OF ALTERNATIVE SOURCES OF ELDERLY INCOME SUPPORT. Like the United States, the other Anglo-Saxon countries are not only due to age less than the developed-world average, but also tend to have modest public pension systems, well-developed funded pension systems, and relatively high rates of elderly labor-force participation. Although there are some important exceptions, the countries of continental Europe tend to have much faster-aging populations, much more generous public pension systems, and fewer alternatives to state retirement provision. Then there is Japan, where the public pension system is not especially generous and where alternative sources of elderly income support are well developed, but which faces the largest age wave of any country on earth. Yet despite this considerable diversity, most of the nine countries have at least one important thing in common: They have taken significant steps to prepare for the aging challenge.

Australia

Australia has largely avoided the concerns about fiscal sustainability that beset retirement systems in other developed countries. Unlike the great majority of countries, it never established a contributory, earnings-related public pension scheme similar to Social Security. Instead, its public pension system, called the Age Pension, provides a noncontributory, flat-rate, means-tested benefit to all Australian residents aged 65 and over, an eligibility age that is scheduled to rise to 67. Since the means test is fairly liberal, a majority of Australians qualify. As of 2012, more than two-thirds of Australians of pensionable age were receiving either a full or a partial Age Pension. This means-tested floor of old-age income support is supplemented by a large, mandatory, and fully funded occupational pension system or superannuation scheme, which the Australians call “Super.” The system, which was first put in place in the mid-1980s, has been steadily expanded over the years. Contribution rates, which were initially set at 3 percent of payroll, are now 9 percent and due to rise further to 12 percent over the next five years. Overall, roughly 90 percent of the workforce now participates in Super, a rate of private pension coverage that, among the nine countries covered in the report, is only equaled by the Netherlands and Sweden.

Australia's retirement system is not without its problems. Pension rules allow workers to withdraw Super funds as early as age 55—the so-called preservation age—encouraging premature retirement and increasing the risk of inadequate income late in life. And though the preservation age is due to be raised to 60, the lack of any annuitization requirement may continue to put workers at risk of outliving their savings. Pension rules also allow many workers to dispose of their lump-sum withdrawals in ways that permit them to qualify for the Age Pension, giving rise to a significant “double-dipping” problem. Still, with its economical public pension system and near-universal private pension system, not to mention its relatively favorable demographics, Australia is well positioned to confront the aging challenge.

Canada

Although Canada's public pension system is not expensive by developed-world standards, it will nonetheless come under significant cost pressure over the next few decades as the country's unusually large postwar baby boom retires. The system consists of two basic tiers. The first tier, known as Old Age Security, provides a modest flat-rate benefit payable to all Canadian residents aged 65 or older. The second tier, known as the Canada Pension Plan, provides a modest earnings-related benefit and is similar in its overall design to Social Security. Together, the two tiers now replace roughly 40 percent of the wages of average earners, about what Social Security does in the United States. For the low-income elderly, there is also a means-tested pension benefit known as the Guaranteed Income Supplement. As in the United States, Canada's public pension system is supplemented by a well-developed voluntary private pension system that includes occupational pensions, personal pensions, and, as of 2012, a special new type of pension arrangement for the self-employed.

Canada has taken some significant steps to limit future growth in public pension costs, including

indexing first-tier Old-Age Security benefits to prices rather than wages and scheduling an increase in the minimum eligibility age to 67. But it is also banking heavily on another strategy that it hopes will mitigate the need for deeper benefit cuts. Beginning in the late 1990s, Canada raised the current contribution rate for the second-tier Canada Pension Plan well above the current pay-as-you-go cost rate in order to build up a large trust-fund reserve. Unlike the similar U.S. trust-fund build-up following the 1983 Greenspan Commission, Canada's reserve is better insulated from its general government budget, and hence is more likely to raise national savings. While the Social Security trust funds are merely memo accounts within the federal budget, the Canada Pension Plan trust fund is managed by an independent agency that invests its assets in marketable securities. Still, despite the more robust firewall between Canada's general government budget and trust-fund administration, the historical failure of governments throughout the world to validate retirement trust-fund savings by running sustained general government surpluses raises serious questions about the long-term success of this strategy.

France

Of all the countries covered in the report, France undoubtedly remains the most wedded to generous pay-as-you-go public pensions, which are viewed as a lynchpin of “social solidarity”—and the most hostile to funded alternatives, which are associated with “Anglo-Saxon capitalism.” Over the years, proposals to reduce the generosity of the public pension system, which now offers replacement rates of roughly 70 percent to average earners, have repeatedly triggered political turmoil, sometimes toppling governments. While many European countries are moving to expand existing funded pension systems or are launching new ones, private pension income in France remains a trivial share of total elderly income—just 1 percent. Retirement ages are also among the lowest in the developed world. All told, just 10 percent

of French adults aged 60–74 are still in the labor force, the lowest share of any of the countries covered in the report.

Yet even France has not entirely resisted the reform wave sweeping the developed world. As expensive as the public pension system remains—its two tiers require a combined contribution rate of over 30 percent of payroll—a series of reforms have chipped away at its long-term cost since the mid-1990s. The number of contribution years required for a full benefit under the first-tier General Regime has been increased, as has the length of the wage history used in calculating benefits. Meanwhile, the minimum retirement age has been raised from 60 to 62. The most consequential reform, however, affects the system’s second-tier ARCO and AGIRC pensions, which, though ostensibly private employer plans, are financed on a pay-as-you-go basis and form an integral part of the public pension system. The reform switched the indexation of the contributions or “pension value points” that are used to calculate new benefit awards from wages to prices. Unlike the modest two-year retirement age hike, which was met with widespread protests, this stealth reform appears to have slipped under the public’s radar. Yet over the next few decades, as average benefits fall steadily relative to average wages, it promises to do much more to reduce the public pension system’s overall generosity.

Germany

A decade or so ago, Germany’s public pension system was much like France’s, with early retirement ages and generous replacement rates of as much as 70 percent for average earners. Since then, however, Germany has undertaken a series of major reforms that have put the country’s Statutory Retirement Pension (GRV) on a much sounder long-term footing. The 2001 Riester reform, named for the labor minister at the time, reduced the generosity of the initial benefit formula, while the 2004 Rürup reform, named for the chairman of the national pension commission that proposed it, raised the normal retirement age from 65 to

67. More importantly, the Rürup reform tried to eliminate the need for further ad hoc fixes by introducing a demographic “sustainability factor” into the GRV benefit formula that indexes both new benefit awards and current pension benefits to the annual change in the dependency ratio of retired beneficiaries to contributing workers. In principle, this reform could have immediately and permanently stabilized total annual pension spending relative to the payroll tax base. As actually designed and implemented, however, the German sustainability factor is weighted so that it offsets just one-quarter of the full shift in the GRV’s dependency ratio.

At the same time, Germany has eliminated a variety of no-penalty early retirement options that allowed many workers to collect full public pension benefits in their late fifties or early sixties. In just the ten years from 2000 to 2010, the labor-force participation rate of adults aged 60–64 doubled from 22 to 44 percent—still far lower than in high-participation countries like Japan and the United States, but nonetheless an impressive improvement. Germany is also moving to expand funded pension savings. It is encouraging employers to convert their traditional book-reserve pensions into externally funded pensions. Meanwhile, it has launched a new voluntary system of funded personal pensions called *Riester Renten*. Although the system got off to a slow start, participation is now rising rapidly, thanks in part to generous government matching contributions for low-earning workers. While Germany spends a lot on public pensions today and will spend even more tomorrow, it has reduced projected costs far beneath what they otherwise would be while at the same time helping to ensure the adequacy of elderly income.

Italy

Italy’s public pension system was long a byword for excessive generosity, with retirement ages in the early or mid-fifties for those qualifying for “seniority pensions” and replacement rates exceeding even those of France and Germany.

Like Germany, however, Italy has enacted a series of far-reaching reforms that are scheduled to greatly reduce the system's generosity. The most important was the so-called Dini reform, passed in the mid-1990s, which initiated a transition from Italy's traditional defined benefit public pension system to a notional defined contribution system. In such systems, worker payroll taxes are credited to individual accounts, where they earn an administratively determined (rather than a market) rate of return—hence the designation “notional.” Upon retirement, accumulated account balances are converted into annuities. In and of itself, the notional defined contribution design does not necessarily restrain demographically driven cost growth. To do so, Italy also built an automatic demographic stabilizer into its new pension system by setting the rate of return on worker accounts equal to the overall rate of growth of the economy, which in turn depends on the rate of growth of the working (and taxpaying) population. In 2011, the government enacted a new series of reform measures that further restrain cost growth by raising the normal retirement age, automatically indexing annuities to life expectancy, and speeding up the transition to the new notional defined contribution system.

According to the Italian government, the cumulative impact of these reforms will be sufficient to keep public pension spending from rising as a share of GDP over the next few decades. Given Italy's massive age wave, this would be a remarkable accomplishment if it comes to pass. Unfortunately, there is reason to doubt that it will. To begin with, there is the reform's lengthy phase in. While Germany's automatic stabilizer was designed to go into effect immediately, Italy's reform, even after the recent acceleration of the transition, will not be fully phased in until the 2030s. This long lag may leave the reform politically vulnerable, especially if Italy fails to do more to shore up elderly living standards as state retirement provision is scaled back. Although elderly labor-force participation is now rising rapidly in Germany, it remains stuck at a very low level in Italy—in fact, only marginally higher than in France. And though Italy, like Germany, is trying to jump start a new funded pension system, participation remains disappointingly low.

Japan

Japan, thanks to its chronically low fertility rate and world-record life expectancy, is ground zero for global aging. Given the magnitude of its aging challenge, it is perhaps not surprising that it has moved sooner and more aggressively than most countries to address it. Since the 1980s, Japan has enacted a long series of reforms to its public pension system, which consists of two tiers: the National Pension Program (which provides a flat-rate benefit to all Japanese residents) and the Employees' Pension Insurance Program (which provides an earnings-related benefit similar to Social Security). Initially, the reforms relied on Japan's traditional consensus politics. At regular five-year intervals, the Ministry of Health, Labor, and Welfare proposed—and the Diet debated and passed—a major reform package that increased contributions and cut benefits. Yet after each round of reforms, new and more pessimistic projections soon showed that the pension system was once again careening toward bankruptcy. By the 2004 round, the need to revisit reform repeatedly and ask the public for additional sacrifice had begun to strain even Japan's legendary capacity for consensus building. As part of the 2004 reform package, Japan therefore decided to add an automatic demographic stabilizer to its pension system. Henceforth, both new benefit awards and current pension benefits were to be adjusted annually by two factors, one designed to offset the decline in the number of contributing workers and the other to offset the increase in the life expectancy of beneficiaries.

Just as with Germany's reform, Japan's in principle could have immediately and permanently stabilized total annual pension spending relative to the payroll tax base. But just as with Germany's,

there is a hitch. The Japanese stabilizer is designed to sunset once average replacement rates fall to 50 percent, something that is projected to happen by the mid-2020s. After that, Japan is counting on drawing down a large trust-fund build-up to keep its public pension system afloat. The bad news is that Japan, like the United States, has failed to save its trust-fund surpluses, meaning that, when the time comes to redeem them, it will face a choice between further contribution hikes and further benefit cuts. The good news is that Japan's high rate of private pension coverage, high rate of elderly labor-force participation, and strong family support networks may help to insulate Japanese elders from what would otherwise be a steep decline in living standards.

Netherlands

The Netherlands' two-tiered retirement system, which includes a large funded component, is very different from those of the other European countries that have been discussed so far. The first public tier of the system, known as the General Old-Age Pension (AOW), provides a flat-rate benefit to all Dutch residents. Although AOW replacement rates are modest by French, German, or Italian standards, the overall cost of Dutch public pensions is increased by generous means-tested supplements and special early retirement programs. The second private tier of the retirement system consists of a quasi-mandatory, fully funded occupational pension system. This system covers some 90 percent of Dutch workers, pays out total benefits roughly equal to total AOW benefits, and has assets totaling over 150 percent of GDP, more than the pension assets of any other developed country, the United States included.

With its relatively modest public pension system and large funded private pension system, one might suppose that the Netherlands would be well positioned to confront its age wave. Yet in fact, the country faces a steep rise in old-age dependency costs as its baby boom, which was one of Europe's largest, reaches retirement age. To

prepare, the Netherlands has curtailed a variety of special no-penalty early retirement options since the mid-1990s, phasing out public programs and eliminating the tax-favored status of private ones. As a result, the elderly labor-force participation rate, which was one of the lowest in Europe, has begun to increase rapidly. In 2012, the Netherlands also took additional steps to rein in public pension costs by scheduling an increase in the minimum AOW eligibility age from 65 to 67 and by providing for its subsequent indexation to life expectancy. Nonetheless, public pension spending is still projected to nearly double as a share of GDP by 2040—a larger increase than in any other country covered in the report. Clearly, the Netherlands' broad-based private pension system can help it confront its age wave by taking pressure off of public budgets. Yet just as clearly, leveraging this advantage will require a more far-reaching reform of its public pension system.

Sweden

Until the late 1990s, Sweden had a traditional defined benefit public pension system consisting of two tiers: a small flat-rate benefit and a larger earnings-related benefit. Amid growing concerns about the impact of population aging on the system's future cost, however, it enacted a landmark reform in 1998 that replaced the second tier of the old system with a notional defined contribution system similar to Italy's. As in Italy, Sweden's system, known as the Income Pension, includes an automatic demographic stabilizer. The mechanism in Sweden's system, however, is more complicated. When the reform was initially designed, the default rate of return to worker accounts was set equal to the rate of growth in average wages rather than to the rate of growth in total payroll or GDP, which meant that an increase in the old-age dependency ratio would still drive up costs. To prevent this from happening, an "automatic balance mechanism" was subsequently added that will kick in and adjust both the return to worker accounts and current pension benefits whenever demographics threaten to push

the system out of long-term balance. Whether or not the automatic balance mechanism is triggered, new benefit awards are adjusted to offset changes in life expectancy. Along with the new notional defined contribution system, the reform also provides for a generous means-tested supplement to replace the old system's first-tier flat-rate pension.

Even as Sweden has stabilized the cost of its public pension system, it appears to be on track to maintain the living standard of the elderly. Sweden has long had a quasi-mandatory occupational pension system that, though not nearly as generous as Australia's or the Netherlands', also covers roughly 90 percent of the workforce. As part of its landmark 1998 reform, moreover, it created a new system of mandatory, fully funded personal retirement accounts that serves as a supplement to the unfunded notional accounts. Although these accounts are individually directed and privately invested, they form an integral part of Sweden's public pension system. Besides its sizeable and growing funded pension system, Sweden also has a higher elderly labor-force participation rate than any of the other European countries covered in the report. These factors should help to ensure the political durability of Sweden's reform. So may the country's relatively favorable demographics, which mean that public benefits will need to be cut much less to stabilize spending than in faster-aging Italy.

United Kingdom

Unlike other European countries, where recent reforms have focused on long-term cost containment, the focus in the UK has been on shoring up the overall adequacy of the retirement system, which consists of a relatively modest public pension system supplemented by a large, but patchwork, private pension system. To understand today's policy focus, we need to go back to the late 1970s, when the UK, faced with projections showing that the aging of the population would soon put intense pressure on public budgets, launched a far-reaching overhaul of the public pension system. The reform switched the indexation of the first-tier Basic State Pension, which provides a flat-rate benefit, from wages to prices, while downsizing the second-tier earnings-related pension. To substitute for scaled-back state retirement provision, the reform at the same time tried to encourage the expansion of the UK's existing voluntary system of funded occupational pensions, while also establishing a new voluntary system of personal pensions.

In the wake of the reform, which flattened projected public pension spending as a share of GDP, the UK was hailed by many as the only developed country to have met its aging challenge. However, as price indexation caused public pension benefits to decline steadily as a share of wages—and as voluntary private pension provision failed to expand as expected—the UK policy debate was gradually transformed from one about how to afford public benefit promises to the elderly to one about how to ensure the elderly an adequate living standard. In 2007, amid an emerging consensus that price indexation would ultimately impoverish the elderly, the government enacted a major new reform that re-indexed the Basic State Pension to wages and mandated the enrollment of most workers (with an opt out option) in either an occupational pension plan or a new publicly administered personal pension plan called the National Employment Savings Trust or NEST Pension. While the 2007 reform also scheduled a gradual increase in the retirement age from 65 to 68, the net result was to once again put public pension spending on a rising trajectory. Compared with a decade ago, the UK now looks considerably better on the income adequacy front, but it also looks considerably worse on the fiscal sustainability front. ▶

CHAPTER THREE

Lessons for U.S. Policymakers

THE MOST FUNDAMENTAL PROBLEM WITH AMERICA'S CURRENT ENTITLEMENT SYSTEM IS THAT THE MAJOR RETIREMENT AND HEALTH-BENEFIT PROGRAMS ARE SET ON A RISING AUTOPILOT. Social Security benefit awards are directly indexed to wage growth, while Medicare and Medicaid benefits are in effect indexed to an expanding package of medical services whose cost tends to rise much faster than wages. With the ratio of beneficiaries to workers due to surge over the next few decades, total spending will climb inexorably as a share of workers' wages and government outlays—regardless of other competing budgetary priorities and regardless of society's ability to afford it.

The most effective cost-containment strategy will be one that builds automatic cost constraint rather than automatic cost growth into the entitlement system. To have a lasting impact, that strategy will also have to be accompanied by other measures that help to ensure income adequacy for the elderly. A successful entitlement reform strategy must be a balanced strategy—and not just for equity reasons. If entitlement reform comes at the expense of social adequacy, the fiscal savings it seems to achieve may in the end prove illusory.

The Global State of the Art in Entitlement Reform

Over the years, U.S. policy experts have considered a variety of approaches for building automatic cost constraint into the entitlement system. One strategy that was much discussed in the 1990s is to relate benefits to need rather than age. When today's pay-as-you-go entitlement programs were put in place or expanded in the early postwar decades, age alone seemed to be a reasonable proxy for financial need and diminished capacity for work. But with elderly incomes now equaling or exceeding those of the nonelderly in the United States and many other developed countries—and with health spans rising—this is no longer the case. Despite its intrinsic appeal, however, means-testing has failed to gain much traction either here or abroad. Apart from Australia, no developed country means-tests eligibility for benefits under its main public pension system. And though some countries have public pension systems with progressive benefit structures, many prefer to advance progressivity through means-tested supplements and the full income taxation of benefits. Indeed, the trend in recent years has been

to strengthen rather than to weaken the link between contributions and benefits, which is one of the goals of the notional defined contribution model. Policymakers in other countries appear to understand that undermining individual equity in public pension systems may also undermine broad-based popular support for those systems, a risk often overlooked by U.S. proponents of eliminating Social Security's "max tax" or adding additional "bend points" to its benefit formula.

Another strategy that has been much debated is to index new benefit awards to prices rather than wages. Price indexation was seriously considered by the architects of the 1977 Social Security rescue legislation, and though the idea vanished for a while after the 1983 Greenspan Commission seemed to restore Social Security to long-term balance, it resurfaced during the 2005 Social Security debate and continues to have many proponents today. There is no question that the price indexation of new benefit awards can be an extremely effective long-term cost-containment strategy. The problem, as we have seen, is that it is a blunt instrument. It cuts pension benefits more when wages grow rapidly than when they grow slowly, which is the opposite of what sensible policy should do. Moreover, it does not stop when cost-containment goals have been achieved. As the UK has learned, it just keeps going.

A more calibrated, and arguably more equitable, approach would be to index benefits to changes in life expectancy. Recognizing that life spans have risen dramatically over the postwar era while average retirement ages have fallen, a growing number of countries are embracing this strategy. As we have seen, Italy and Sweden have indexed the annuity payments in their notional defined contribution systems to life expectancy, while the Netherlands has indexed the eligibility age for public pension benefits to life expectancy, which amounts to the same thing. Many other developed countries, the United States included, have taken a first tentative step in this direction by phasing in ad hoc increases in either the mini-

imum eligibility age for public pension benefits or the normal retirement age—that is, the age at which full benefits are payable. It is important to understand, however, that even fully indexing benefits to changes in life expectancy can only partially offset the impact of population aging on entitlement costs. After all, population aging is not only—or even primarily—driven by increases in life expectancy. The aged dependency ratio of retirees to workers is also rising because falling fertility is hollowing out the base of the population pyramid and because, in countries like the United States, the retirement of large baby booms is leaving it top-heavy with elders.

To find the global state of the art in entitlement reform, U.S. policymakers will need to look elsewhere to the more comprehensive automatic stabilizers that countries like Germany, Italy, Japan, and Sweden have introduced into their public pension systems. These stabilizers may differ in design, but they have two crucial characteristics in common. First, they are all expressly designed to offset the full impact of demographically driven cost growth. And second, they are all self-adjusting. In effect, they put entitlements on a new kind of autopilot—one that is preprogrammed for cost constraint rather than for cost growth.

To be sure, the automatic demographic stabilizers adopted in other countries still leave considerable room for slippage. The Italian stabilizer only affects future benefits after what, for most workers, will be a long lag, increasing the political risk that it may never be implemented. The Swedish stabilizer is designed to nudge the pension system toward long-term balance, rather than to ensure pay-as-you-go balance in every year. The German stabilizer is weighted so that it only partially offsets the pension system's deteriorating demographics, while the Japanese stabilizer is designed to sunset. Still, all of these reforms constitute major steps toward stabilizing public pension spending relative to the payroll tax base and the economy.

Many pension experts believe that the notional defined contribution model for public pension systems is superior to the traditional defined benefit model—and it is true that the model has certain advantages.⁷ Most importantly, since lifetime benefits exactly reflect both the magnitude and timing of lifetime contributions, notional defined contribution systems encourage work effort and reward later retirement. There is nothing inherent in the design of these systems, however, that ensures their sustainability. Since notional defined contribution systems are still pay-as-you-go, their financing remains hostage to demographics unless additional steps are taken. The Italian and Swedish systems stabilize pension costs as a share of GDP because the rate of return to contributors' accounts is ultimately pegged, directly or indirectly, to the rate of growth in the payroll tax base. As Japan and Germany have demonstrated, this same stabilization can be achieved by indexing existing defined benefit systems to a country's changing demographics.

While switching to a notional defined contribution system would be a complex process entailing a lengthy transition, adding a stabilizer similar to Germany's or Japan's to the U.S. Social Security system would not be technically challenging. In principle, an automatic stabilizer could also be applied to Medicare, provided that its benefits were first capitated—that is, converted into a fixed annual outlay per beneficiary rather than the cost-plus system we have today. If this were done, Medicare growth could be constrained by the same kinds of mechanisms that are now being applied to public pension systems in many other countries.

Beyond their policy advantages, other countries are finding that automatic demographic stabilizers can have political advantages as well. The fact that the incremental benefit cuts they trigger are small in any given year has helped to defuse a potential public backlash. Meanwhile, political leaders have perceived an advantage in enacting self-adjusting reforms that may spare them from having to repeatedly revisit a divisive political issue in future years. To be sure, reforms to popular benefit programs can never be entirely insulated from political review and revision—nor should they be. Over the past few years, both Germany and Japan have temporarily suspended their demographic stabilizers in response to the economic and financial crisis. Still, switching the default indexing option from automatic cost growth to automatic cost constraint might fundamentally change the politics of U.S. entitlement reform.

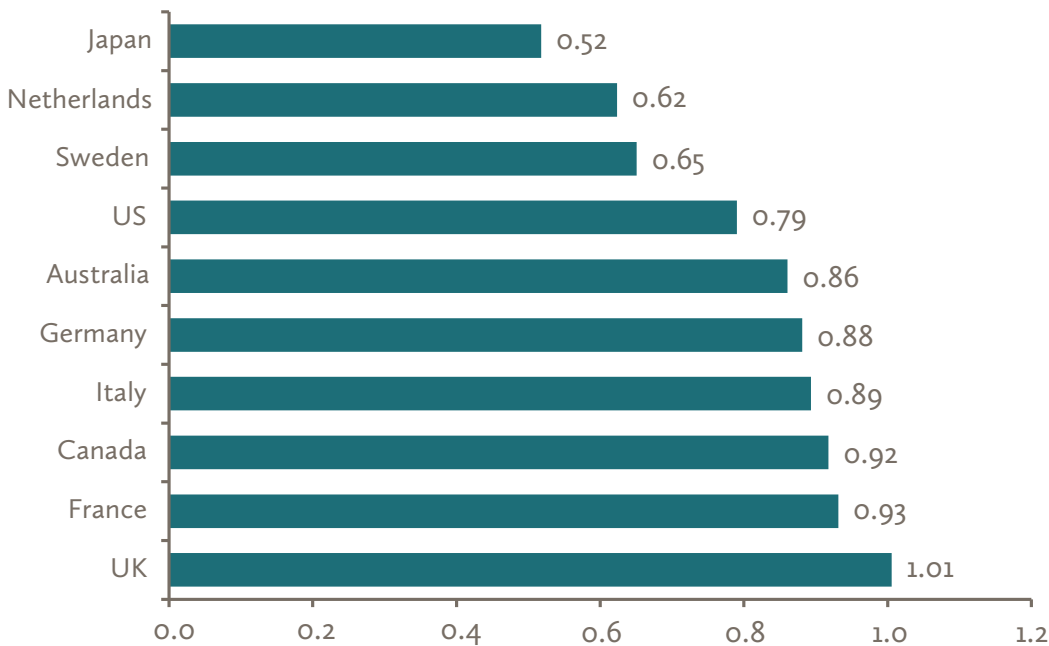
Balancing Adequacy and Sustainability

Stabilizing long-term entitlement costs does not alone add up to a complete reform strategy. As the United States reduces the future fiscal burden of old-age benefit programs, it must seek to maintain—or even to improve—the overall adequacy of the retirement system. Here too, the experience of other developed countries offers some useful lessons.

The first step is to reallocate some of the savings to strengthening old-age poverty projection. Even as they have reduced the overall generosity of state retirement provision, many developed countries have expanded supplemental means-tested support for the low-income elderly. The United States would be well advised to do the same. Although other countries have not

7. See, for instance, Richard F. Disney, "Notional Accounts as a Pension Reform Strategy: An Evaluation," Social Protection Discussion Paper no. 9928 (Washington, DC: World Bank, 1999); Edward E. Palmer, "The Swedish Pension Reform: Framework and Issues," Social Protection Discussion Paper no. 0012 (Washington, DC: World Bank, 2000); and John B. Williamson, "Assessing the Notional Defined Contribution Model," Issue in Brief no. 04-24 (Boston: Center for Retirement Research at Boston College, October 2004).

FIGURE 6: PER CAPITA RATIO OF AVERAGE AFTER-TAX “OLD ELDERLY” (AGED 70 & OVER) TO “YOUNG ELDERLY” (AGED 60–69) CASH INCOME IN 2010



Source: The Global Aging Preparedness Index, Second Edition

done so, the United States might also consider tempering the impact of a demographic stabilizer on the low-income elderly by relating the size of automatic benefit cuts to income, an idea analogous to “progressive price indexation” proposals. Alternatively, benefits could be reduced more steeply for the “young elderly” (under age 70) than for the “old elderly” (aged 70 and over), who on average are less able to work, are more dependent on public benefits, and have lower overall incomes. (See figure 6.) However it is done, strengthening the old-age safety net is particularly important for a country like the United States, where the elderly have one of the highest relative poverty rates in the developed world.

As the United States shores up public support for the low-income elderly, it will also have to ensure that the middle-income elderly have adequate alternative means of support that pick up where public benefits leave off. There are two ways to do so, the first being to encourage or require individuals to save more for retirement during their working years. As we have seen, those

countries that already have large funded pension systems are trying to strengthen them. Meanwhile, countries that historically have leaned heavily on pay-as-you-go systems are trying to jump start new funded ones. Germany has launched a new voluntary personal pension system, while Italy is transforming its traditional severance pay system into a genuinely funded occupational pension system. Even Sweden, Europe’s quintessential welfare state, has established a mandatory system of funded personal retirement accounts to supplement the public pension system’s unfunded notional accounts. Only France seems immune to the trend.

The other way to maintain or improve the living standard of the old without imposing a new tax or family burden on the young is to extend work lives. For decades, many developed countries, especially in Europe, heavily subsidized early retirement on the mistaken assumption that bribing older workers to exit the labor force would create jobs for younger workers. Over the past ten to fifteen years, however, the trend toward ever earlier retirement has been decisively reversed. As we have seen, several

countries have recently curtailed or eliminated special no-penalty early retirement options. Many others are raising the minimum eligibility age for benefits under their regular public pension system, or else are increasing the system's normal retirement age. The result is that elderly labor-force participation has risen significantly since the 1990s in most of the countries covered in the report, and in some it has risen steeply. The exceptions are France and Italy, where it remains stubbornly low, and Japan, where it has always been high. (See table 2.)

The United States probably needs to worry less about increasing elderly labor-force participation rates than most of the other nine countries. The share of the U.S. elderly who remain in the labor force is already relatively high by developed-world standards, and surveys suggest that it is likely to rise further as the boomer retirement gets into full swing.⁸ Despite recent reforms, many other countries still have public pension systems whose contribution and benefit rules

reward early retirement and penalize late retirement. In contrast, Social Security, at least on the benefit side, is actuarially neutral. Compared with most other countries, moreover, the United States has more flexible labor markets, more robust age discrimination laws, and a broader and better-developed range of work options, such as “phased retirement,” that appeal to older workers. If other countries are leading the way in reforming entitlement programs, the United States is leading the way in promoting “productive aging.”

On the other hand, the United States needs to worry a great deal about increasing funded retirement savings. Many studies have concluded that Americans are undersaving for retirement—and that, as a result, the living standard of tomorrow's retirees may fall well short of that of today's retirees, even without factoring in the impact of possible future entitlement reforms.⁹ This development has many complex contributing causes, including the ongoing shift from defined benefit to defined contribution pensions, the less favorable labor-market and

TABLE 2: ELDERLY LABOR-FORCE PARTICIPATION RATE BY AGE GROUP, 1990–2010

	AGED 60–64			AGED 60–74		
	1990	2000	2010	1990	2000	2010
Australia	33%	34%	52%	22%*	25%*	40%*
Canada	37%	36%	51%	20%	19%	32%
France	14%	11%	19%	8%	5%	10%
Germany	21%	22%	44%	12%	11%	18%
Italy	22%	19%	21%	12%	10%	11%
Japan	56%	56%	61%	44%	41%	44%
Netherlands	15%	19%	39%	8%	10%	23%
Sweden	58%	53%	65%	25%	26%	34%
UK	38%	38%	46%	19%	19%	27%
US	45%	47%	55%	27%	30%	39%

*Data refer to the population aged 60–69.
Source: *Labor Force Statistics Database* (OECD, 2013)

8. Between 1996 and 2013, for instance, the Employee Benefit Research Institute reports that the share of all workers who expect to retire before age 60 has dropped from 21 to 9 percent while the share who expect to retire after age 65 (or “never retire”) has risen from 14 to 43 percent. See *Retirement Confidence Survey* (Washington, DC: Employee Benefit Research Institute, 1996 and 2013).

9. For a summary of perhaps the best known study on the subject, see Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, “The National Retirement Risk Index: An Update,” Issue in Brief no. 12-20 (Boston: Center for Retirement Research at Boston College, October 2012).

housing-market experience of younger generations, and changing patterns of family life, which will result in a rapid growth in the number of never-married and divorced elders. What the experience of other countries teaches, however, is straightforward: The surest way to increase retirement savings is to mandate it. While Australia, the Netherlands, and Sweden, with their mandatory or quasi-mandatory funded pension systems, have coverage rates of around 90 percent of the workforce, no country with a voluntary system has boosted coverage much higher than 50 or 60 percent of the workforce. Still, even if a savings mandate is the only certain way to ensure adequacy, there are reforms that can improve the reach of voluntary systems. One promising approach is to subsidize the retirement accounts of low-earning workers through government matching contributions, as Germany is doing. Another is to require the automatic enrollment of all workers in an occupational or personal pension, but to allow them an opt out option, as the UK is doing.

The importance of balancing fiscal sustainability and income adequacy cannot be overestimated. Unless reductions in the generosity of state retirement provision are accompanied by other reforms that at the same time help to develop alternative sources of income support, governments may well face a backlash from their aging electorates. Policymakers who believe that the two dimensions of aging preparedness can be divorced should heed the example of the UK, whose bold move to switch from wage indexation to price indexation was ultimately reversed amid growing concern that the reform would impoverish the elderly. The lesson is that, in the long run, it may be no more feasible to have an entitlement system that is fiscally sustainable but socially inadequate than it is to have a system that is socially adequate but fiscally unsustainable.

The U.S. Entitlement Paradox

In the end, this review of reform initiatives abroad leaves us with an apparent paradox. Several of the

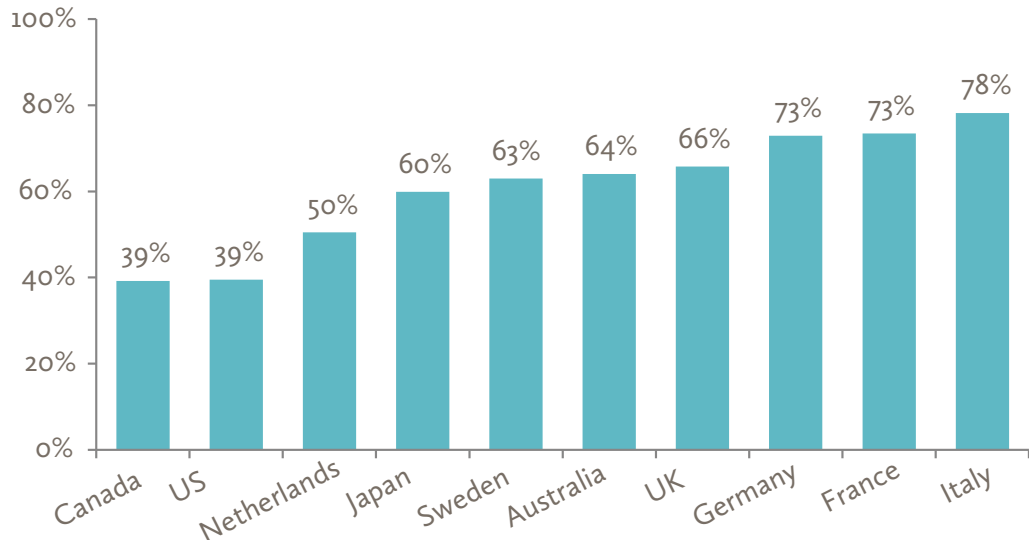
countries that have been most aggressive in controlling the long-term cost of their age waves have large and popular welfare states that have historically proved resistant to cost containment. Retirees in much of Europe receive almost all of their personal income from public pensions, which are considered cornerstones of social democracy. In Sweden, 63 percent of the cash income of the middle-income elderly came in the form of a government check in 2010. In France and Germany 73 percent did and in Italy 78 percent did. Meanwhile in the United States, with its traditions of limited government and financial self-reliance, the equivalent share was 39 percent. (See figure 7.)

Why then have these other countries been able to grapple with the challenge of rising old-age dependency costs while the United States has not? Part of the explanation may be that the challenge has appeared less urgent in the United States. Until recently, America's age wave still loomed over the horizon, while in Europe and Japan aging populations have been burdening public budgets, forcing up payroll tax rates, and slowing economic growth for decades. The sense that addressing the challenge is less urgent may also be reinforced by America's seeming ability to borrow without limit. The dollar's status as the global reserve currency may confer considerable economic advantages, but it also fosters a false sense of invulnerability.

Part of the explanation may also lie in America's peculiar entitlement ethos. In Europe's welfare states, government benefit programs are part of a social contract that is often shaped by negotiations between the "social partners"—that is, business and labor. The programs may be fiercely defended, with the opponents of reform calling general strikes and erecting barricades in public squares. But in the end, everyone understands that the social contract is subject to renegotiation and revision. The United States also has a welfare state, but, in the memorable formulation of Peter G. Peterson and Neil Howe, ours is a "libertarian welfare state."¹⁰ We have a welfare state because

10. Peter G. Peterson and Neil Howe, *On Borrowed Time: How the Growth in Entitlement Spending Threatens America's Future* (San Francisco: Institute for Contemporary Studies, 1988).

FIGURE 7: PUBLIC BENEFITS AS A PERCENT OF THE CASH INCOME OF THE MEDIAN-INCOME ELDERLY IN 2010*



*Income refers to the third quintile of the elderly income distribution
Source: The Global Aging Preparedness Index, Second Edition

we empower government to redistribute income in peacetime. But our welfare state is libertarian because much of the public views government benefit programs, and especially Social Security and Medicare, as quasi-contractual arrangements between individual citizens and the state, rather than as social welfare with a public purpose. Paradoxically, this mindset, which is encouraged by the misleading insurance metaphors in which the programs are cloaked, may make old-age benefits more difficult to reform in the United States than in Europe's large welfare states.

To be sure, it may be that some of the progress other countries have made is more apparent than real. There are, after all, two ways to look at the difference between the current-law and current-deal projections discussed earlier in the report. One is that some countries have already made a lot of progress in reducing the fiscal burden of their aging populations. The other is that these same countries have a lot of benefit-cutting to do over the next few decades just to keep costs from rising even higher than official government projections now indicate they will. Given the high level of benefit dependence in most of the countries that are making deep cuts in the generosity of their public pension systems, it is an open question whether some will be able to stay the course. The prospects may be reasonably good for Germany and Sweden, which are filling in the emerging gap in elderly income with funded retirement savings, or for Japan, with its broad private pension coverage, high rate of elderly labor-force participation, and strong family support networks. They are more doubtful for Italy, whose reform grandfathered nearly everyone old enough to vote, or for France, whose price indexation of the second tier of its public pension system was never clearly advertised to the public.

Still, however these reforms ultimately play out, there is no denying that many other countries have so far confronted the aging challenge with greater seriousness than the United States has. Significantly, the impetus for reform has not always come from the right. While the Italian, Swedish, and UK reforms were initiated by center-right governments, the Australian and German reforms were initiated

by labor governments. And though reforms have sometimes been reversed when the party in power has changed, as ultimately happened in the UK, more often than not they have ended up acquiring broad support across the political spectrum. This success is undoubtedly due in large part to the considerable attention that the architects of reform paid to coalition building. Yet the very fact that political leaders in other countries were able to build broad coalitions in favor of entitlement reform suggests that they have grasped a deeper truth that most U.S. political leaders have not. This truth is that the unchecked growth in old-age benefit spending threatens the agendas of both right and left. In the end, it will not only prove inimical to small government, but to progressive government as well.

The most important lesson to be learned from other countries is thus the simplest: As daunting as the aging challenge may be, it is possible to forge consensus around effective and equitable reforms. There is still time for U.S. policymakers to take up the challenge. But the longer they wait, the more painful the choices will become. ▶

Technical Note on Data and Sources

With the exception of historical data on U.S. fertility rates, which come from the U.S. Census Bureau, all demographic data cited in this report come from *World Population Prospects: The 2012 Revision* (New York: UN Population Division, 2013). Population projections refer to the UN’s “constant fertility variant” projection. The author prefers this projection to the UN’s “medium variant” projection, which arbitrarily assumes that fertility rates in all countries will eventually converge at the 2.1 replacement rate. There is little theoretical or empirical support for this assumption, and in fact fertility rates in most of the countries covered in the report appear to have stabilized around their current levels.

All projections of public old-age benefit spending, as well as all data on elderly and nonelderly income (both total and by type) and elderly poverty rates come from *The Global Aging Preparedness Index, Second Edition* (Washington, DC: Center for Strategic and International Studies, 2013). Data on elderly labor-force participation rates come from the OECD’s Labor Force Statistics Database; data on the public debt come from the IMF’s Economic Outlook Database and refer to gross public debt at all levels of government; historical growth rates in real age-adjusted per capita public health-care spending were calculated by the author based on data from OECD Health Data 2012.

The projections of old-age benefit spending used in the report divide public benefits into three categories: public pensions, health benefits, and other benefits. The public pension category includes all social insurance retirement and survivors benefits, all means-tested retirement benefits, and all government employee pension benefits that are financed on a pay-as-you-go basis. The health benefits category includes both acute-care services and long-term care. The other benefits category includes everything else, from disability and unemployment benefits to nutritional and housing subsidies. The definition of funded pensions used in the report is quite broad. It includes public plans and private plans, occupational pensions and personal pensions, and defined benefit and defined contribution schemes.

Throughout the report, the “elderly” are defined as persons aged 60 and over and the “nonelderly” as persons under age 60. This threshold between elderly and nonelderly may strike some readers as both arbitrary and early—and indeed it is. The threshold, however, is not meant to indicate anything about health, vigor, or capacity to work at older ages. Age 60 was chosen because it is close to the typical age of first entitlement to public retirement benefits in most countries, and because a large share of these benefits—at least one-third in every country covered in the report, including the United States—now flow to adults in their early and mid-sixties. If the threshold between elderly and nonelderly were set at age 65 or 70, the projections would seriously understate old-age dependency burdens.

The discussion of public pension reforms in other countries is based on dozens of sources, including government reports, scholarly articles, and statistical almanacs. Among the most important are: the OECD’s *Pensions at a Glance*, 2013 (Paris: Organization for Economic Cooperation and Development, 2013); the EU’s *2012 Ageing Report: Country Fiches* (Brussels: European Union Economic Policy Committee, 2012); and the relevant volumes of SSA’s *Social Security Programs throughout the World* (Washington, DC: Social Security Administration and International Social Security Association, 2012). The discussion also relies heavily on James C. Capretta, *Global Aging and the Sustainability of Public Pension Systems: An Assessment of Reform Efforts in Twelve Developed Countries* (Washington, DC: Center for Strategic and International Studies, 2007). ▶

About the Author

RICHARD JACKSON is currently a senior associate at the Center for Strategic and International Studies (CSIS) and a senior advisor to the Concord Coalition. From 2003 to 2013, he was a senior fellow at CSIS, where he directed the Global Aging Initiative, a research program dedicated to exploring the economic, social, and geopolitical implications of demographic trends, and especially population aging, in the United States and around the world.

Jackson is the author or co-author of numerous policy studies, including *Balancing Tradition and Modernity: The Future of Retirement in East Asia* (2012); *Global Aging and the Future of Emerging Markets* (2011); *The Global Aging Preparedness Index* (2010); *The Graying of the Great Powers: Demography and Geopolitics in the 21st Century* (2008); *Long-Term Immigration Projection Methods: Current Practice and How to Improve It* (2007); and *The Graying of the Middle Kingdom: The Demographics and Economics of Retirement Policy in China* (2004).

From 1993 to 2002, Jackson worked as an independent researcher, writer, and consultant on public policy issues. From 1988 to 1992, he was a research fellow at the Hudson Institute, where he contributed to the path-breaking Workforce 2000 Project.

Jackson regularly speaks on long-term demographic and economic issues and is widely quoted in the media. He holds a Ph.D. in history from Yale University and lives in Alexandria, Virginia, with his wife Perrine and their three children, Benjamin, Brian, and Penelope.

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