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SCHWARTZ CENTER FOR ECONOMIC POLICY ANALYSIS
POLICYNOTE

THE NEED FOR MORE SOCIAL SECURITY AND SECURE PENSIONS

by Teresa Ghilarducci, Bernard L. and Irene Schwartz Professor of Economics at The New School for Social Research and Director of the Schwartz Center for Economic Policy Analysis (SCEPA), and Amanda Novello, Research Associate

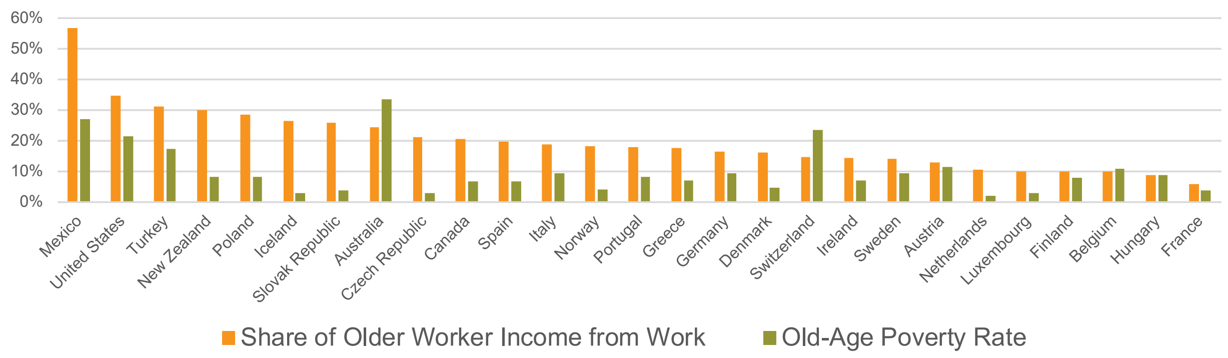
ELEVATOR PITCH

Retirement systems in rich nations have shifted away from pay-as-you-go (PAYGO) social insurance programs towards financially-based, advance–funded retirement accounts. Depending on the design, financialized retirement systems shift the risks of accumulation, investment, and longevity from employers and governments to individuals. Because individuals are less able to manage these risks, the combination of financial volatility and longer lives leads to inadequate savings. Reliance on individually-directed financial accounts rather than social insurance erodes retirement income security, cuts retirement time (especially for lower-income groups), requires more people to work in old age, and raises the risk of old-age poverty.

KEY FINDINGS

- Between 1993 and 2010, residents of the 35 richest (OECD) countries experienced more time in retirement due to increased average life spans, rather than earlier retirement.
- Older people are working more in almost all OECD countries. Men over 65 increased their labor force participation by 35% and women over 65 by 77%.
- There is no evidence that longevity improvements lead to older retirement ages. In the United States, older women increased their labor force participation by 89% compared to the OECD average of 77%. However, their longevity increased by only 8.5%, less than the OECD average longevity improvement of 13%.
- In countries where older people work more, rates of old-age poverty are higher and retirement time is shorter.

FIGURE 1: Higher Old-Age Poverty Levels in Nations Where Older People Work More



Sources: Organisation for Economic Co-operation and Development (OECD). 2011. *Pensions at a Glance 2011.* Paris, France: OECD; Organisation for Economic Co-operation and Development (OECD). 2015. *Ageing and Employment Policies – Statistics on Average Effective Age of Retirement (a).* Paris, France: OECD.; Organisation for Economic Co-operation and Development (OECD). 2015. *Pensions at a Glance 2015 (b).* Paris, France: OECD.

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TWENTY YEARS OF AUSTERITY AND PENSION FINANCIALIZATION

Since the 1990s, rich countries have reduced government pension benefits mostly by raising the age people can collect a full benefit. At the same time, nations have advanced tax breaks and permissive legal frameworks to promote individual financial wealth as a source of retirement income.

This brief shows that shifting risks to individuals by moving away from PAYGO plans is likely to have two effects.[1] First, the shift will diminish the time some elders spend in retirement – especially those who need to stay in the labor force longer due to a lack of financial means or financial and life losses. Second, since retirement systems that rely on personal asset accumulation work best for those with more education, higher incomes, or steady jobs, elder poverty rates may increase for those who don't fit in these categories.

The financialization of retirement is defined as a set of institutions and policies aimed at increasing the share of retirement income coming from financial assets rather than social insurance programs.[2] Sometimes financialization is described as giving workers what they want, such as more personal responsibility and control over their assets. Sometimes the policy shift is aimed at reducing the costs of a rapidly aging population by incenting people to extend their working lives by shrinking the value of life long pensions.[3]

The extent of financialization varies by country. In some nations, the elderly obtain more income from capital than others. For example, on average, Canadian elders get 40 percent of their income from bonds and stocks, while Slovakian elders receive less than 1 percent from these sources (Figure 2).

Nor are all forms of advance-funded pensions the same. In the United States, policy makers have let Social Security and employer-based defined benefit pensions erode while promoting voluntary, individually-directed, commercially-run, 401(k)-type plans. After fees, tax subsidies, and incentives are taken into account, the net rate of return on retirement plan contributions are higher for higher-income workers. Also, payouts are made in a lump sum rather than as annuities.

In Switzerland, workers and employers are required to advance fund their pensions, but the system does not shift accumulation, investment, and longevity risks to individuals. Because contributions to occupational plans are mandatory and rates set by the government, retirement accumulations are adequate. With a set minimum rate-of-return, individuals are protected against full investment risk. And because annuities are required for payout, individuals receive lifetime payments to protect against longevity risk.

FIGURE 2: Retirement Income Financialization by Nation

Country	Share of income from capital for people over 65
Slovak Republic (2000)	0.7%
Poland	1.0%
Czech Republic	1.5%
Hungary	2.5%
Greece	4.3%
Austria	4.7%
Belgium	5.8%
Ireland	6.3%
Netherlands	6.6%
Portugal	7.1%
Italy	7.7%
Norway	8.6%
Finland	8.8%
Germany	10.8%
Iceland	11.2%
Switzerland	11.2%
Luxembourg	11.3%
Sweden	11.9%
Spain	12.4%
Mexico	12.8%
United States	12.9%
Australia	17.0%
Denmark	18.7%
France	19.7%
Turkey	19.8%
New Zealand	24.4%
Canada	40.6%

Source: Organisation for Economic Co-operation and Development (OECD). 2011. *Pensions at a Glance 2011.* Paris, France: OECD.

OECD RETIREMENT TIME INCREASED, BUT GAINS VARIED

The time people spend in retirement increases when they retire earlier and live longer. If people retire at the same age and elder longevity grows, retirement time increases. However, in some nations, people spend more years working (measured by labor force participation). If labor force participation outpaces longevity gains, time in retirement time is cut short.

Between 1993 and 2010, women increased their time in retirement by 8 percent and men by 13 percent (see Figure 3).[4] Unfortunately, one of the reasons women's retirement time didn't increase as much as men's is the raise in the age women can claim retirement benefits. In the name of gender equality, OECD nations raised the eligibility age for women to collect full retirement benefits to the higher age requirement for men, which cut women's overall retirement benefits. As a result, older women's labor force participation rate increased by 77 percent, while men's increased 34 percent. In addition, longevity gains for older women lagged behind older men. Age-65 longevity (or life expectancy after one reaches age 65) for women increased 13 percent, whereas men's increased 20 percent.

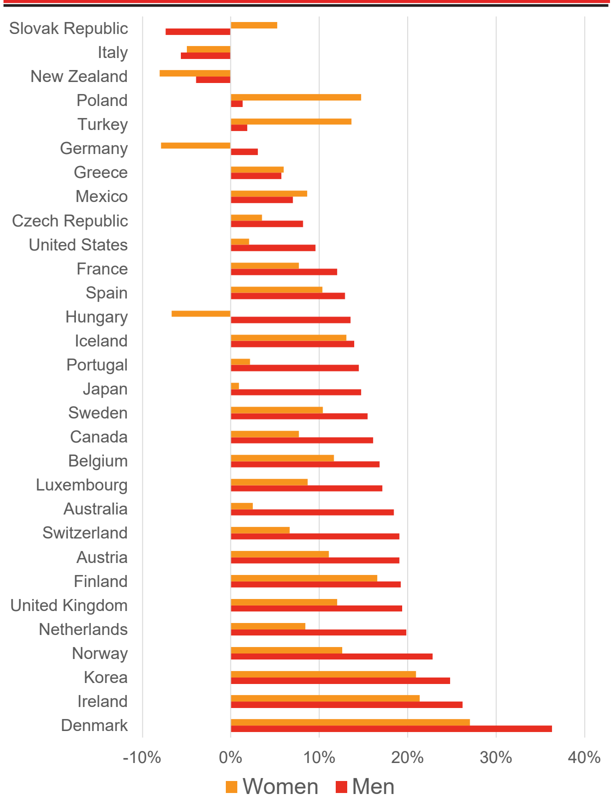
PENSION FINANCIALIZATION IS LINKED TO MORE WORK AND POVERTY

Older people work longer in countries with greater pension financialization. In the 30 wealthy nations of the OECD, the labor force participation of men and women has grown significantly since 1993.[5] Evidence suggests that elders work longer when their pensions are more uncertain. In the nations with more pension financialization (defined as higher shares of old-age income coming from capital), the labor force participation rates of older workers increased (see Figure 4). The simple two-way correlation is positive and significant at 36%. (The correlation is not 100 percent and correlation is not causation. Other factors also affect elder work and financialization).

And, in nations where older people have a higher share of retirement income coming from capital, such as in Mexico and the United States, they have higher rates of elderly poverty. Countries with a prevalence of retirement income derived from social insurance, such as Finland, Belgium, and Luxembourg, have lower rates of elderly poverty (Figure 1). Evidence suggests that nations that prioritize other goals before the need to secure elder income tolerate higher levels of elder poverty. The simple two-way correlation is positive and significant at 38%. (Again, the correlation is not 100 percent and correlation is not causation.)

Financialization is likely linked to higher elder poverty rates for two reasons. First, policies that shift away from defined benefit-type retirement systems are often associated with austerity measures, such as reducing unemployment benefits, increasing the normal age to claim pension benefits, and reduced social spending. Under austerity policies, nations cut public spending on programs such as those working to secure seniors' incomes and prioritize a nation's standing in the financial community. Second, income from personal assets is less secure, as it is subject to market fluctuations and income shocks such as job loss, divorce, and health crises.[6]

FIGURE 3: Gender Gap in Retirement Time by OECD Nation, 1993-2010



Source: Organisation for Economic Co-operation and Development (OECD). 2015. *Ageing and Employment Policies – Statistics on Average Effective Age of Retirement (a).* Paris, France: OECD.

POLICY RECOMMENDATIONS FOR AMERICAN PENSION REFORM

The shift toward pre-funded pensions forms a general pattern of OECD reform, though national reforms have taken place at different paces and to different extents. As many nations in the OECD shrink their social insurance programs, more elders will obtain retirement income from individually-saved or -invested assets. The reduction in retirement time will not be shared across income classes. Those who were unlucky in the financial markets, paid high fees, or suffered life shocks that prevented sufficient asset accumulation will seek to work longer and suffer a greater reduction in retirement time.

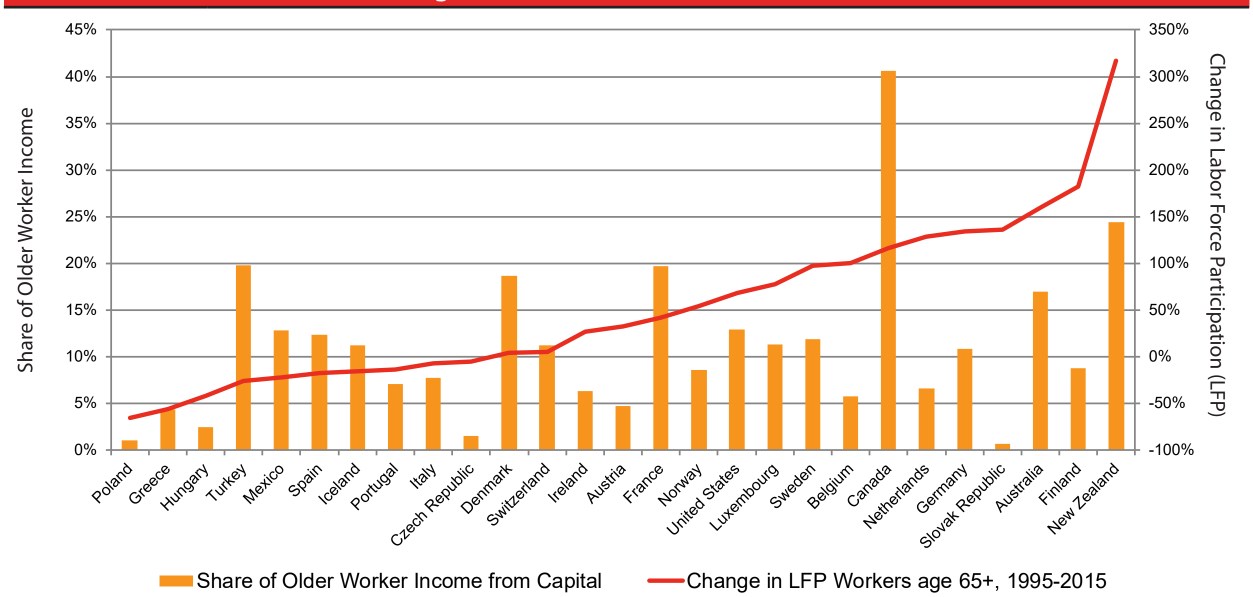
The shift from the security of social insurance to the insecurity of financially-based retirement accounts will likely result in the (perhaps intended[7]) consequence of increased elderly labor force participation rates. It will also surely result in the unintended effects of regressive cuts in retirement time and more old-age poverty. Social Security should be expanded to prevent old age poverty and secure pension income, supported by the research of Economists Jonathan Gruber and David Wise.

National reform efforts need to find an optimal policy mix of PAYGO and advance-funded elements to create sustainable retirement income security systems. The resulting policy must be sure to avoid discouraging labor force participation for those who choose to continue working, while discouraging work as a solution to widespread financial need.

It must allow for equal access to retirement time, regardless of lifetime income levels. And it must eliminate elder poverty. Hybrid systems that pair the strengths of social insurance with those of advanced-funded pensions are advisable if the advanced-funded layer is structured correctly. No nation relies entirely on a PAYGO social insurance system for their citizens' retirement income security. Funding pensions in advance drastically cuts the costs paid by the youngest generation for the older generation's pensions.

However, financialized systems are not equal. Governments and employers should bear the investment and longevity risks. Unlike households, governments can spread losses and gains over a longer period.

FIGURE 4: Workers Stay in the Labor Force Longer in Countries with Higher Levels of Pension Financialization



Sources: Organisation for Economic Co-operation and Development (OECD). 2015. *Ageing and Employment Policies – Statistics on Average Effective Age of Retirement (a)*. Paris, France: OECD; Organisation for Economic Co-operation and Development (OECD). 2015. *Pensions at a Glance 2015 (b)*. Paris, France: OECD.

Good financialized systems assign risk appropriately, ensure adequate contributions, structure returns and incentives fairly, and guarantee life-long incomes. The Guaranteed Retirement Plan proposed by Ghilarducci and James is structured to close the gap between how much workers have saved and how much they need.[8] The GRA plan is similar to the Swiss model. American workers aged 40-55 have an average $14,500 saved for retirement, well below the $290,000 needed for the median earner in that age. The GRA is a self-funding pension to supplement Social Security payments that is funded by mandatory contributions of a minimum 3 percent of workers' pay, half of which is paid by the employer. Low-income earners would receive tax credits to offset their contributions. A PAYGO Social Security system and an appropriately financialized advanced –funded layer can work together to ensure workers of all income levels access to retirement.

ENDNOTES

1. The brief relies heavily on material in Ghilarducci, T. and Novello. A. 2018, The Labor Consequences of Financializing Pensions. Forthcoming in the Labor Employment Relations Association (LERA) Research Volume 2018. Bridget Fisher, Andrew Minster, and Anthony Webb deserve special thanks for their incisive editing and comments.

2. Financialization is a historical socio-political and economic transition in which an increased share of national output is generated by the financial sector and households increasing rely on financialization. Scholars use "financialization" to denote more exposure to financial markets as a source of income. Financialization requires individuals to bear the financial, investment, and timing risks and the skill to become financially literate. More state effort for regulations, and individuals face more exposure to financial fraud and predation. This shift to financialization of retirement plans in the U.S. is described as the shift from defined benefit plans to defined contribution plans.

3. Queisser, Monika. Edward Whitehouse, Peter Whiteford. 2007. The public–private pension mix in OECD countries. Industrial Relations Journal 38(6), 542-568.

4. Gruber, J., & Wise, D. 1998. Social Security and Retirement: An International Comparison. The American Economic Review, 88(2), 158-163. The retirement time gains were larger in earlier years of course. Life expectancy improvements will naturally slow as we reach our upper limit of a human life span and, second, older people worked more. Between 1958 and 1993, the estimated average retirement time for 30 OECD nations increased over 20 percent, with a 29 percent increase in retirement time for women and a 23 percent boost for men. Between 1971 and 1993 men's retirement time increased by 22 percent and women's by 19 percent.

5. Gruber, J., & Wise, D. 2000. Social security programs and retirement around the world. In *Research in Labor Economics* (pp. 1-40). Emerald Group Publishing Limited.

6. Ghilarducci, Fisher, Radpour, Saad-Lessler 2017. Why Retirement Savings Fall Short. National Endowment for Financial Education. Accessed October 27, 2017. https://nefe.org/Portals/0/WhatWeProvide/PrimaryResearch/PDF/Why-Retirement-Savings-Fall-Short-Executive-Summary.pdf?ver=2017-07-14-140038-653

7. See Gruber and Wise 1998 and 2000.

8. Ghilarducci, Teresa and Tony James. 2018. Rescuing Retirement. New York: Columbia University Press

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