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US RETIREMENT INCOME SYSTEM

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In the United States, retirement income is supplied through the combination of a relatively modest, contributory social insurance programme; employer-provided (increasingly defined contribution savings) programmes; and individual retirement savings. The public programme supplies the vast majority of the income of the poorer half of the aged population; only the richest 20 per cent receive more from employer plans than from the public programme. Projections show that the public programme will have financial problems in the 2030s. Thereafter, revenues would have to be increased by a third or benefits cut by a quarter to restore financial balance. Despite widespread angst *about the impact of longer lifespans and the retirement of the baby-boom generation, however, there is little serious discussion about how either the public- or private-sector programmes should be adjusted. In 2005, President Bush failed to generate significant public support for a plan partially to privatize the public-sector programme.*

I. INTRODUCTION

Broadly speaking, the historical development, basic structure, achievements, and future prospects of the retirement income system in the United States parallel those of most of the rest of the developed world. For the most part, the system grew up in the first two decades following the Second World War, though some elements can trace their lineage to the late nineteenth century. It has become an essential part of the fabric of society, freeing most participants from the need to work during the final fifth of their lives, and yet allowing them to continue to live independently and in dignity.

In contrast, the basic approach to health-care financing in the United States differs significantly from that found in the rest of the developed world. The United States has no national health service, no national health insurance, and very little regulation of the prices of many health services, notably prescription drugs. Programmes are available to help cover the medical costs of the aged, but they require the aged to cover a significant portion of

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Any views expressed are solely those of the author and not necessarily those of the Urban Institute or its funders. The description here applies to the system in existence at the end of 2005.

their health costs out of their own resources. Because of this arrangement, increases in health costs are both a fiscal challenge for the government and a threat to retirement income adequacy among the aged.

By most measures, the retirement income system has been very successful and is immensely popular. The system now faces some serious challenges, however. Chief among these are the impacts of population aging and of health-cost escalation, each of which threatens to make the system as it currently exists unaffordable in the future.

This paper describes the current US retirement income system, outlines the challenges it currently faces, and discusses the prospects for addressing those challenges. It focuses primarily on the institutions that provide income support to the aged population, but cannot avoid some mention of health-cost issues, since developments in these two areas are so closely linked.

II. THE CURRENT RETIREMENT INCOME SYSTEM

The retirement income system in the United States relies on a combination of public-sector programmes, private-sector programmes, and individual private efforts, though most of the private programmes and many of the private individual efforts enjoy public subsidies in the form of tax preferences. If the richest 10 per cent of the aged population is excluded, the public programmes and the various private-sector efforts supply roughly equal shares of the aggregate income of the aged. The public-sector programmes are dominant among the lower half of the income distribution, however, while the private programmes are dominant among the upper half.

(i) Public Programmes

The foundation of the system is a contributory social insurance programme popularly known as 'Social Security', which provides cash benefits to the aged, survivors, and the totally disabled.[2] Social Security covers virtually the entire economically active population.[3] It is financed almost entirely from employer and employee contributions.[4] The total contribution rate is 12.4 per cent, divided equally between employers and employees, and levied on all annual earnings up to a specified ceiling. That ceiling was $90,000 in 2005, about 2.5 times the national average of annual earnings under the programme.[5] The ceiling is sufficiently high that only about 7 per cent of the work-force earns more in any given year and roughly 85 per cent of all earnings in employment under the programme are taxed. The ceiling is adjusted annually in line with the growth in average earnings. Of the 12.4 per cent contribution rate, 1.8 per cent finances disability benefits and the remaining 10.6 per cent finances retirement and survivors' benefits.

Benefit amounts are based on a measure of the individual worker's career average earnings and calculated using a formula that scales retirement benefits to prior earnings but redistributes from higher earners to lower earners. The career average is calculated by indexing the worker's actual prior earnings for changes in average wage levels and computing the monthly average of the highest 35 annual indexed amounts. This indexed average wage figure is then multiplied through a three-bracket formula to produce the basic retirement benefit. The formula is adjusted annually in line with

[2] The official name is Old-age, Survivors' and Disability Insurance (OASDI). 'Social Security' is a term coined in the 1930s to refer to the entire package of income support programmes (including unemployment insurance and social assistance) contained in the 'Social Security Act of 1935'. In the USA, the term subsequently became identified solely with the OASDI programme, even though it retained its original meaning in most of the rest the world. A detailed summary of current programme provisions is available in the Annual Statistical Supplement to the Social Security Bulletin (US Social Security Administration, 2004).

[3] The only significant group not covered by the programme is certain employees of state and local governments in jobs that are covered by alternative pension programmes. The self-employed, members of the armed forces, federal civilian employees, and most employees of state and local government are covered.

[4] Excluding investment earnings, social insurance contributions provide 93 per cent of total annual receipts. The other 7 per cent comes from a budget transfer calculated to represent a specified fraction of the revenue derived from subjecting the cash benefits paid to higher-income individuals to the federal income tax.

[5] In the annual actuarial report issued in April 2005, average earnings under the programme in 2005 were estimated to be $36,600 (see Board of Trustees of the Federal Old-age, Survivors, and Disability Insurance Funds, 2005).

Table 1
Social Security Benefits and Replacement Rates for Hypothetical Workers with Full Career of Constant Relative Earnings

Illustrative worker	Earnings relative to national average (%)	Annual earnings (2004, $)	Annual retirement benefit (2005, $)	Replacement rate (%)
Low earner	45	15,821	9,305	58.3
Average earner	100	35,157	15,335	43.2
High earner	160	56,251	20,222	36.1
Maximum earner	245	87,900	23,285	30.1

Source: Board of Trustees of the Federal Old-age, Survivors' and Disability Insurance Funds (2005).

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the growth of average earnings so that the whole structure of new benefit awards grows over time at the same rate as average earnings are growing.[6]

The basic retirement benefit is the benefit paid to someone retiring at the 'normal retirement age'. Until 2001, the normal retirement age was 65, but under legislation enacted in 1983, it is now gradually rising. It is 66 for persons turning 62 in 2005 and will be 67 for those turning 62 in 2022 and later.[7] Benefits are available as early as age 62, but they are permanently reduced if taken early. Those reaching age 62 in 2005 would receive 75 per cent of their basic retirement benefit if they filed for it on their 62nd birthday. Those reaching age 62 in 2022 will receive 70 per cent of their basic benefit at age 62. After retirement, benefits are indexed for inflation.

The data in Table 1 show retirement benefits and replacement rates for illustrative workers after a full career of steady earnings at various relative levels. The higher earners receive higher benefits than the low earners, but their benefits replace a lower fraction of their pre-retirement earnings.

The illustrative average earner in Table 1 is a common focus for Social Security policy discussions in the USA. The system is usually characterized as paying a benefit of about 43 per cent to an average earner. In actual fact, however, this hypothetical, illustrative worker is substantially better off than the actual average retiree. In 2005, the actual average retired worker benefit was $915 a month, about one-third less than benefit calculated for the illustrative average earner and about 30 per cent of the national earnings average. Two factors account for most of this difference. First, the majority of workers file for benefits when they are 62 years old and receive permanently reduced benefits. Second, many workers, particularly women, have fewer than 35 years of positive earnings, reducing their calculated lifetime earnings average relative to that of the hypothetical average earner.

Persons over the age of 65 are also eligible for Medicare, the health insurance programme for the aged and disabled. Medicare has two (soon to be three) parts. Hospital Insurance (Part A) is contributory social insurance that covers in-patient services and is financed by employer and employee contributions totalling 2.9 per cent.[8] Supplemental Medical Insurance (Part B) is a heavily subsidized, voluntary insurance programme that covers outpatient services. Roughly one-fourth of the cost of the programme is covered through monthly premiums paid by beneficiaries, and transfers from the general budget cover the balance.[9] Beginning in 2006, the

[6] The formula for those reaching age 62 in 2005 is 90 per cent of the first $667 in indexed monthly earnings plus 32 per cent of the next $3,112 and 15 per cent of the remainder. Bracket boundaries are adjusted annually by the rate of growth of average earnings, so each birth cohort has a different benefit formula.

[7] The normal retirement age increased 2 months for each birth cohort beginning with the 1938 birth cohort and ending with the 1943 cohort. It will again increase by 2 months for each cohort born between 1955 and 1960.

[8] The annual ceiling does not limit the earnings upon which Hospital Insurance contributions must be paid.

[9] Beginning in 2007, beneficiaries with very high incomes will have to pay higher Part B premiums. By 2011, a single individual with annual income in excess of $200,000 will have to pay enough to cover 80 per cent of the cost of the programme, or some 3.2 times the premium charged to average and below-average earners (Fronstin *et al*., 2004).

Table 2
Percentage Distribution of Employees Participating in Employer-sponsored Retirement Plans

Type of pension plan	1983	1998
DC only	15	59
DB only	40	20
Both	45	20

Source: Friedberg and Owyang (2002).

aged will also have the option of buying subsidized insurance covering the cost of prescription drugs, to be known as 'Part D'. This insurance will be offered through private insurance companies. It is expected that the average premiums will cover about 15 per cent of the total cost of the programme, with the balance financed by additional transfers from the general budget.

The Part B premium is deducted from participants' Social Security cheques. In 2005 the premium was $78.20, some 8.5 per cent of the average monthly cash benefit. The average Part D premium is expected to be $32 a month. Most middle- and upper-income beneficiaries also purchase private insurance to cover some or all of the health expenses not covered by Medicare. The cost of these policies varies geographically and according to what they cover, but typically runs at about $100 a month. That would represent another 11 per cent of the average benefit. (The cost of some of these policies will fall when the new prescription drug benefit comes into effect.) Persons with incomes below 120 per cent of the poverty line may be eligible to have their Medicare premiums and all or a portion of their deductibles and co-payments covered by a separate, means-tested medical assistance programme.

(ii) Employer-sponsored retirement programmes

Employer-provided retirement programmes first emerged in the late nineteenth and early twentieth centuries, initially in large manufacturing and transportation companies and later in the public sector. Employer-sponsored programmes spread particularly rapidly during the decade of the 1950s, during which the fraction of private-sector wage and salary workers covered by pensions increased from about 25 per cent to about 50 per cent (Seburn, 1991). Coverage rates continued to increase, though more slowly, through the early 1970s, but they show no clear trend since then (Reno, 1993).

Until recently, most employer-sponsored programmes were defined benefit (DB) plans and, at least in the private sector, were typically financed entirely by the employer. Employers often offered additional retirement savings opportunities through voluntary defined contribution (DC) arrangements, but these were usually supplements to the basic DB. Most (currently 90 per cent of) public-sector employers continue to offer DB pension plans, but beginning in the 1980s, the structure of private-sector retirement plans changed significantly. Increasingly, those private-sector employees who are offered any plan at all are offered only a DC plan. In 1983, only 15 per cent of employees participating in employer-sponsored retirement plans were with an employer that offered only a DC plan. By 1998, almost 60 per cent of participating employees had this kind of arrangement.

In 2001, 62 per cent of all wage and salary workers aged 21–64 worked for an employer that offered some form of retirement plan. Four out of five of these workers participated in the employer plan. Among full-time and full-year workers, 68 per cent had an employer-provided plan and seven out of every eight participated in the plan. Among those who did not participate, some were not eligible to participate (most likely because they had worked for their employer for less than a year) and the rest chose not to participate.

Both the availability of employer-sponsored plans and the probability that an employee will participate in an available plan vary widely. Private employers are less likely to offer retirement plans than are public-sector employers and, among employers offering plans, employees in the private sector are less likely to participate than employees in the public sector. Younger workers and lower earners are less likely to have an employer-sponsored plan available and are less likely to participate when one is offered. Small employers are less likely to offer a plan than larger employers, but participation rates among those that do offer a plan are similar to those for larger employers.

The most common form of DC plan is a salary-reduction plan (or '401(k)' plan) under which individual workers elect to divert a portion of their salary to accumulate a tax-deferred retirement account.[10] Income taxes are deferred on amounts diverted to these accounts (up to a specified annual limit) and on investment earnings until the resources are withdrawn from the account.[11] A recent study of the salary-reduction plans operated by larger employers found that 90 per cent of the employers provided matching contributions, sometimes in shares of the company's stock.[12] Among the plans in the study, employee contributions averaged 6.8 per cent of pay and, among employers that provided a matching contribution, the average employer contribution was 3.2 per cent of the employee's pay (Holden and Van Derhei, 2001). Since the employers in the sample tended to be larger firms, both the incidence and the average size of the employer match may exceed the true national average.

Most salary reduction plans give workers the option of withdrawing all or a portion of their account balances when they cease employment with the plan sponsor. The balances can be shifted to an individual retirement account (discussed shortly) or another employer's retirement plan account with no tax penalty. Otherwise, withdrawal triggers the deferred income tax liability. Use of the funds for a purpose not specifically approved in the law triggers an additional 10 per cent penalty tax.[13] Surveys suggest that only about 40 per cent of the workers who take such lump-sum distributions prior to reaching the minimum retirement age transfer the entire balance to another retirement account. The rest either consume all or a portion of their balance or use it to pay off debts. Leakage out of the retirement income system appears to be a bigger problem among young workers and workers with relatively small balances than among older workers or those with larger balances (Copeland, 2002). To encourage the preservation of account balances for retirement, the law now specifies that account balances in excess of $5,000 are to be automatically converted into individual retirement accounts unless the departing worker makes an alternative selection.

Historically, most DB pension plans required participants to take their benefits in the form of a life annuity, although the supplemental DC, thrift plans typically did not. With the growth of salary reduction plans and the shift to other forms of DC retirement plans, the prevalence of annuity pay-outs has declined. In recent years, moreover, many private DB plans and the nation's largest multi-employer DC plan have allowed participants to select alternative pay-out strategies, including taking their entire balance as one lump sum.[14]

A recent survey of retirees from large salary-reduction plans found that 10 per cent of all retirees were required to take an annuity, 20 per cent were required to take their balance as a lump sum, and 70 per cent had an option. Where multiple options were offered, an annuity was usually one of the options, but only 23 per cent of the retirees having an option selected the annuity option.[15] Broader surveys of

[10] The combination of the higher incidence of such plans in the private sector and the requirement that workers elect to divert a portion of their salary to participate in them may explain why private-sector workers have a lower participation rate than public-sector workers.

[11] The most common salary reduction plan is usually referred to as a '401(k)' plan after the section of the tax law that authorizes the tax preference that these plans enjoy. Technically, however, that section only applies to for-profit companies. Other sections of the tax law enacted subsequently authorize similar plans for non-profit organizations and government agencies. In 2005, the limit on tax-deferred contributions to salary reduction plans was $14,000. The limits are not indexed, but are adjusted periodically by Congress.

[12] About 15 per cent of the assets in 401(k) plans are in stock in the account-owner's employer (Holden and VanDerhei, 2005*b*).

[13] Approved uses vary somewhat from programme to programme. Funds in accounts organized under section 401(k) of the tax code, the most common of the various salary-reduction plans, can be used without penalty if an employee reaches 55, becomes totally disabled, incurs major medical expenses, or uses them to purchase a life annuity.

[14] Traditionally, the largest DC plan, TIAA-CREF, required participants to take life annuities. They dropped the requirement in 1989 and by 2001 only 45 per cent of new retirees selected a life annuity (Yakoboski, 2005).

[15] ICI (2000). Most of the plans that required annuities were sponsored by public-sector or non-profit organizations.

Table 3
Percentage of Workers Whose Employer Sponsors a Retirement Plan and Percentage Who Participate When a Plan is Offered (wage and salary workers aged 21–64; 2001)

	All workers		Full-time, full-year workers	
	Plan available	Participate in plan	Plan available	Participate in plan
All workers	62	81	61	86
By sector				
Private sector	57	79	63	84
Public sector	85	89	89	94
By Age				
20–24	43	48	50	61
55–64	65	87	70	92
By annual earnings				
Less than $20,000	40	54	43	61
$50,000 or more	80	94	81	95
By employer size (private sector)				
Fewer than 10 employees	23	80	27	86
10–99 employees	40	77	49	82
1,000 employees or more	78	80	82	85

Source: Copeland (2003).

the retiree population find that only about 12 per cent of retirees converted salary-reduction plan balances into annuities (Olsen and Yakoboski, 1997).

Annuities in the USA are either fixed in nominal terms, grow annually at a predetermined fixed rate, or fluctuate each year in line with the value of a specified investment portfolio. Since the US government now sells price-indexed bonds, it is theoretically possible to purchase a price-indexed annuity by buying one whose value is tied to a portfolio of these indexed bonds, but apparently few people now do that.

Household surveys found that 25 per cent of all Americans aged 21–64 owned a 401(k)-type account at the end of 2001. On average, owners had contributed for 7.2 years to their accounts. The average (mean) balance was $36,244, but the median value was only $15,000, suggesting that a large fraction of the accounts have rather modest balances. Older workers, those aged 55–64, had contributed an average of 10.3 years and had account balances roughly double the average for all workers (a mean of $62,438 and a median of $30,000). The distribution of account ownership varies by income level in much the same way as the distribution of retirement plan participation varies (Copeland, 2004).

(iii) Individual Retirement Accounts

Individual retirement accounts (IRAs) are tax-deferred retirement savings accounts that individuals create themselves. The self-employed, employees not covered by an employer-sponsored retirement plan, and lower-income individuals who are covered by an employer-sponsored plan are allowed to contribute to such accounts (up to a specified annual limit) on a tax-preferred basis. Non-working spouses of workers eligible to participate in tax-deferred IRAs may also contribute to an IRA. Contributions may be deducted from their taxable income in the year that it is made and income tax on both the contribution and investment earnings deferred until funds are withdrawn. Alternatively, contributions can come from after-tax income, in which case all withdrawals are tax exempt (that is, investment earnings are never taxed).[16] Contribution limits for

[16] Persons who do not qualify to deduct their contributions from their taxable income can still contribute to an IRA and defer tax on their investment earnings.

most IRAs are only about one-third of the limits for salary reduction plans.[17] Self-employed individuals can either create an IRA or set up a somewhat different form of self-directed retirement savings account that is available only to the self-employed. The alternative allows substantially higher total annual contributions.[18]

Workers separating from an employer that sponsors a retirement plan can transfer their vested balance in the employer-sponsored plan to an IRA without generating a tax liability. Such 'rollovers' appear to be the source of about half of the assets now held in these accounts.

The rules for withdrawing IRA balances are similar to those for withdrawing balances in employer-sponsored salary-reduction plans, with a few significant differences. The age limit for IRAs is 59½, whereas that for salary-reduction plans is 55, provided the individual is no longer working for the plan sponsor. On the other hand, IRA balances may be withdrawn without penalty under certain circumstances in which salary-reduction plan balances cannot be withdrawn, including the purchase of a first home, expenses for higher education, and the purchase of health insurance by an unemployed worker. In either case, withdrawals must begin by the age of 70.

At the end of 2001, about 18 per cent of Americans aged 21 and older had IRAs. Average balances were similar to those found in salary-reduction plans. Overall, the mean account balance was $37,015 and the median was $15,000. Among those aged 55–64, the mean balance was $58,169 and the median was $25,000.[19]

III. INCOME OF THE AGED

The US retirement system produces a rather unequal distribution of retirement incomes, and projections indicate that the distribution may become even more unequal in the future. In a research project financed by the US Social Security Administration, the Urban Institute, a non-profit, non-partisan research institution in Washington, recently prepared detailed projections of the impact of current trends on the level and distribution of the income of the population of the aged.[20] Some of the results are summarized in Tables 4 and 5.

The figures in Table 4 show estimated average per capita income at age 67 for workers retiring today and for those that will retire some 30 years in the future. Estimated incomes are expressed as a ratio to national average Social Security earnings in the year each worker turns 67. The first column of figures is the estimate for the entire sample of people in each cohort. The next five columns divide each cohort into income quintiles. The last two columns show the impact on average incomes when the richest 5 per cent of the population is excluded.

Average total income at age 67 for all workers retiring in the early 2000s (the 1936–40 birth cohort) is estimated to be 1.02 times average earnings. The

[17] In 2005, contributions to most IRAs were limited to 100 per cent of earned income or $4,000 per year for those under age 50 and $4,500 for those aged 50 and over. Under a law passed in 2002, the contribution limits are scheduled to increase to $5,000 and $6,000 for those under and over 50 respectively in 2008 and to be adjusted in line with price increases thereafter. Technically, the limits fall to $3,000 a year in 2011 if the Congress does not renew the 2002 law before then.

[18] The alternative accounts are known as 'Keogh plans'. Contributions to these plans are limited to 25 per cent of net earnings from self-employment, but can be as much as $42,000 a year (including any sums contributed to other tax-qualified plans that year). The $42,000 ceiling also applies to employer contributions to a regular DC (as opposed to salary-reduction) plan.

[19] In 2005, a $100,000 balance in the federal government's salary reduction ('Thrift Savings') plan would buy an annuity of about $366 a month if the annuity is taken at age 62, the benefit is price indexed (up to a maximum of 3 per cent per year), and a surviving spouse receives 100 per cent of the monthly benefit. This is the set of features closest to those offered under Social Security. A $100,000 balance thus translates into a benefit equal to 40 per cent of the average Social Security benefit; a $50,000 balance provides 20 per cent. The annuity rates offered under the federal government's plan are probably more favourable than most. See the annuity calculator at www.tsp.gov

[20] The project, entitled 'Modeling Income in the Near Term (MINT)', developed estimates of the economic status of successive cohorts of retirees up to and including the year 2039. The projections used household-level information collected in the 1996 waves of the US Census Bureau's Survey of Income and Program Participation (SIPP), matched to the actual Social Security historical earnings records of the respondents. The economic status of future retirement cohorts was based on information about their economic and demographic status in 1966 and projections of the changes in earnings, pension benefits, housing, and financial assets likely to occur over the subsequent 40 years. The process and results are described in Smith *et al*. (2005).

Table 4
Ratio of Average Per-capita Income at age 67 to National Average Earnings under Social Security by Source of Income and Income Quintile

	Income quintile							
	Total sample						95% sample	
Income source	All	1st	2nd	3rd	4th	5th	All	5th
1936–40 birth cohort (aged 67 in 2003–7)								
Social Security	0.28	0.15	0.27	0.29	0.32	0.35	0.27	0.35
Financial income	0.39	0.01	0.07	0.15	0.27	1.43	0.19	0.50
DB pension income	0.15	0.02	0.06	0.15	0.23	0.31	0.15	0.36
Imputed rental income	0.05	0.01	0.04	0.05	0.06	0.09	0.05	0.08
Total non-labour income	0.87	0.22	0.43	0.64	0.87	2.18	0.66	1.29
Labour income	0.15	0.01	0.04	0.11	0.20	0.37	0.14	0.40
Total income	1.02	0.23	0.48	0.75	1.07	2.55	0.80	1.69
1966–70 birth cohort (aged 67 in 2033–7)								
Social Security	0.26	0.14	0.25	0.28	0.30	0.35	0.26	0.35
Financial income	0.70	0.03	0.08	0.16	0.27	2.95	0.22	0.65
DB pension income	0.09	0.01	0.03	0.05	0.09	0.25	0.08	0.24
Imputed rental income	0.05	0.02	0.03	0.04	0.06	0.11	0.04	0.09
Total non-labour income	1.10	0.20	0.39	0.53	0.71	3.66	0.60	1.33
Labour income	0.20	0.01	0.05	0.13	0.29	0.52	0.20	0.61
Total income	1.30	0.21	0.43	0.66	1.01	4.18	0.79	1.94

Source: The Urban Institute, MINT4 (Smith *et al.*, 2005).

Table 5
Percentage Distribution of Non-labour Income at age 67 by Source of Income and Income Quintile

	Income quintile							
	Total sample						95% sample	
Income source	All	1st	2nd	3rd	4th	5th	All	5th
1936–40 birth cohort (aged 67 in 2003–7)								
Social Security	32	70	62	46	37	16	41	27
Financial income	45	6	15	24	31	66	28	38
DB pension income	18	8	14	23	26	14	23	28
Imputed rental income	6	6	9	8	7	4	7	6
Total non-labour income	100	100	100	100	100	100	100	100
1966–70 birth cohort (aged 67 in 2033–7)								
Social Security	24	69	65	53	41	10	43	26
Financial income	63	15	21	30	37	81	36	49
DB pension income	8	4	7	10	13	7	13	18
Imputed rental income	5	7	8	7	8	3	8	7
Total non-labour income	100	100	100	100	100	100	100	100

Source: The Urban Institute, MINT4 (Smith *et al.*, 2005).

average for workers in the 1st quintile, however, is only 0.23 times average earnings, while that for workers in the 5th quintile is 2.55 times average earnings. Average income for the richest quintile is ten times the average for poorest quintile and five times the average of the 2nd quintile. Of the total income flowing to the current retirement cohort, one-half accrues to the richest 20 per cent, while the poorest 20 per cent receive just 4.5 per cent. The richest 5 per cent of the cohort accounts for 17 per cent of the cohort's total income, and excluding them from the analysis would cause the global average to drop by 22 percentage points.

Average Social Security benefits for the poorest quintile are only about half the average for the cohort as a whole, but among the top four quintiles, average Social Security benefit levels do not vary substantially. The progressive benefit formula compresses the benefit distribution among all but the poorest recipients. Among the top four quintiles, income differences are dominated by the variation in income from financial assets and, to a lesser degree, income from work and from DB pension plans. These income patterns reflect the patterns of pension plan participation and of the asset balances in retirement accounts that were discussed in the previous section. DB pensions and asset income accrue primarily to the upper half of the income distribution. Asset income is heavily concentrated among the richest, as indicated by the large difference between mean and median balances in retirement accounts.

The projections suggest that the overall average income at age 67 will rise more rapidly than average earnings over the next 30 years, but this increase is entirely the result of an increase in asset income accruing to the richest quintile and particularly to the richest 5 per cent. Among the four bottom quintiles, income at age 67 is projected to decline relative to average earnings. Relative to average earnings, average income is projected to decline by about 10 per cent in the 1st and 2nd quintiles and by about 17 per cent in the 3rd and 4th quintiles. If the richest 5 per cent are excluded, even the top quintile experiences a slight decline relative to average earnings. In these projections, the income distribution becomes even more skewed, so that 30 years hence the richest 20 per cent of the retirement cohort will account for almost 65 per cent of the cohort's total income and the richest 5 per cent will account for over a third of the total.

The trends captured in these projections reflect the interaction of two major factors: differences in the cohorts' economic status during their working years and the shift in the structure of the retirement income system. Members of the younger cohorts are less well educated, have lower earnings, and (except for the richest) fewer assets than did the members of the older cohorts when they were a similar age. In the methodologies employed for these projections, this translates into lower pensions and smaller retirement asset holdings. The somewhat larger decline experienced by the 3rd and 4th quintiles is largely the result of the decline in DB pensions, which were not as important a source of income for the 1st and 2nd quintiles. The projections suggest that the decline in DB pensions will not be offset by an increase in DC balances.

Table 5 shows the relative importance of the different retirement (i.e. non-labour) income sources to the members of each quintile.[21] Among the cohort now retiring, financial assets are the single most important income source, followed by Social Security and DB pensions. The primacy of financial asset income is due entirely to the large amounts accruing to the richest 5 per cent, however. Among the remaining 95 per cent of the population, Social Security is half again as important as financial assets; it is the most important source of income for all but the highest income quintile. The projections suggest that, if the richest 5 per cent are excluded, Social Security income will actually be relatively more important 30 years from now. While the gradual increase in the normal retirement age will cause Social Security benefits to fall slightly relative to average earnings, DB pension benefits (and, hence, the other sources of retirement income) fall even more rapidly. The projections suggest that 30 years from now Social Security will remain the most important source of income for all but the highest income quintile.

An assessment of the adequacy of the income of the aged in the USA depends on the standard used to

[21] Social assistance income is not shown separately in these tables, which is why the components for the 1st quintile add to only 90 per cent.

Table 6
Poverty Rates for Aged and for all Individuals (%)

	US official poverty definition		40% of median income definition	
Year	All individuals	Aged individuals	All individuals	Aged individuals
1959	22.4	35.3		
1974	11.2	14.6	10.7	16.5
1991	14.2	12.4	12.1	12.6
2000	11.3	9.9	10.8	15.0
2004	12.7	9.8		

Source: US Census Bureau and Luxembourg Income Study.

measure it. In the 1960s, the US government developed a set of rather arbitrary poverty standards to assess the adequacy of the incomes of different segments of its population.[22] It has continued to use these standards ever since in measuring poverty. The standards bear no particular relationship to average income levels in the population as a whole. They are updated annually to reflect changes in the general price level, but not changes in general living standards. The data in Table 6 show poverty rates at different points in time for the aged (those aged 65 and over) and the population as a whole as measured by the official government standards. For comparison, it also shows poverty rates as measured by one of the poverty definitions used more generally in the developed world.

The first attempt to measure poverty in the USA used data on incomes in 1959. At that time, the government found that over one-third of the aged were poor, half again the rate for the population as a whole. General economic growth halved the poverty rate for the population as a whole between 1959 and 1974. Economic growth, the maturation of the private pension system, and some substantial Social Security benefit increases in the 1960s and early 1970s caused the rate for the aged to fall even faster. By the 1990s, in the official statistics, the poverty rate for the aged had fallen below that for the population as a whole. Since 1991, the rate for the aged has continued to drift down, while that for the population as a whole has shown no clear trend.

A different picture emerges when poverty is measured relative to the median income of the population. If poverty is defined as having income less than 40 per cent of the median, some 15 per cent of the aged were poor in 2000, and the poverty rate for the aged was half again the rate for the population as a whole.[23]

The differences in the method for updating these two poverty lines suggest that the differences between the two will grow over time. The income projections just noted suggest that the income of future retirees, particularly moderate and lower income retirees, is likely to fall relative to incomes of the population as a whole, implying a rising rate of aged poverty when measured as a ratio to the median. Retirement incomes are likely to rise more rapidly than prices, however, implying a declining rate of aged poverty when measured against the US government's official poverty criteria.

IV. CURRENT POLICY DEBATES

There appears to be little interest at the moment in addressing retirement income issues in a comprehensive and coherent fashion. Instead, policy dis-

[22] The original poverty lines were derived by multiplying the cost of a minimally adequate food budget by three, and making some rather arbitrary adjustments for age of head, rural and urban residence, and family size.

[23] Apparently the relatively more favourable rate for the non-aged is the product of two offsetting impacts. The poverty line in the USA is significantly lower than 40 per cent of median earnings, so the poverty rate before adjustment is substantially higher using the median earnings measure. In the figures reported here, however, the analysts at the Luxembourg Income Study have made adjustments to reflect income taxes, which, in the USA, include refundable tax credits for the working poor. These have the effect of removing a number of the non-aged from poverty, but cause little change in the poverty rate among the aged.

cussions and legislative activity in several distinct but related areas proceed independently. The two highest-profile policy discussions involve the structure and financial status of the Social Security programme and the impacts of rising health-care costs on both the financial status of Medicare (the national programme of health insurance for the aged and disabled) and the economic status of the aged population. Less prominent discussions focus on ways to increase participation in either individual or employer-sponsored private retirement savings programmes and how to protect the benefit promises of the remaining private-sector, DB pension programmes. There is virtually no discussion of the economic status of the aged as a whole or of the relationships among these different topics.

(i) Social Security Reform

At least during the first half of 2005, the retirement policy debate with the highest profile was that surrounding the structure and financing of the Social Security programme. Each year the government updates and releases projections of the financial status of the Social Security and Medicare programmes for the next 75 years. For a number of years, these projections have shown that both programmes will face serious financial difficulties as the baby-boom generation moves into retirement.

Social Security programme finances are handled through a special Treasury account. All contribution income is deposited in the account and all programme expenditures are charged to the account. The balance in the account earns interest at the government bond rate.[24] So long as this account has a positive balance, the programme runs on automatic pilot, requiring no further action by the Congress or the President.[25] On the other hand, there is currently no authority to pay benefits from any other source, so that (absent a change in the law) full benefits could not be paid if the balance in the account ever fell to zero.

For the past 20 years, the income from Social Security payroll tax contributions has been substantially higher than annual Social Security expenditures, causing the balance in the programme's special account to grow. The annual surpluses will continue until the baby-boom generation begins to retire at the end of this decade, after which rising benefit payments will produce growing annual deficits. Under the most recent projections, annual expenditures will begin to exceed annual contribution income beginning in 2017, by which time the balance in the account will equal 4.5 times annual expenditures or about 20 per cent of gross domestic product (GDP). The projected 2017 account balance is large enough to cover the annual deficits for another quarter century, so that the account is not exhausted until 2041 (Board of Trustees of the Federal Old-age, Survivors' and Disability Insurance Funds, 2005). By that time, annual expenditures will have risen to exceed annual income by over 30 per cent.

The most common metric used to measure the financial condition of Social Security is the average actuarial balance over the next 75 years. It is computed by dividing projected income and projected outgo in each future year by that year's projected total earnings subject to the Social Security tax. On this measure, the system had an average deficit of just under 2 per cent of taxable payroll according to the valuation prepared in early 2005. Bringing the system into 75-year balance would require: (i) an increase of 2 percentage points in the combined contribution rate (from 12.4 to 14.4), effective immediately; (ii) a cut of some 12 per cent in programme expenditures, effective immediately; (iii) some combination of the two; or (iv) progressively larger rate or benefit adjustments with delayed effective dates.

The use of the 75-year figure to frame the policy debate, while following long-standing practice, has the drawback of understating the size of the longer-run problem, since it involves averaging years of surplus in the near term with years of rising deficits in the out years (the last 40 or 50 years of the projection period). While the average gap is about 2 per cent of total wages over the entire 75-year projection period, by 2040, when account exhaus-

[24] Actually, there are two accounts, one for disability insurance and one for retirement and survivors insurance. The balances are 'invested' in special-issue government bonds that pay the average long-term government bond rate prevailing at the time of issue and can be redeemed at any time at par.

[25] The Congress does have to appropriate funds to cover the administrative costs each year, however.

tion is now projected, the gap between annual income and outgoings is projected to be over 4 per cent, and by 2080, the end of the valuation period, it is projected to be almost 6 per cent.[26] In other words, the eventual adjustments will have to be some two to three times larger than suggested by the 75-year average calculation.

As significant as this sounds, the financial problem in the pension programme actually would be fairly manageable if it were the only long-term fiscal challenge facing the government. While the projected 2080 deficit looms large compared to current contribution rates, it is actually less than 2 per cent of the projected GDP and, therefore, a smaller problem than is posed by the government's current fiscal deficit. The more worrisome trend involves heath-care costs. Similar long-range projections of the Medicare programme suggest that net outlays could exceed scheduled payroll tax contributions by 5 per cent of GDP in 2040 and 10 per cent of GDP in 2080.[27] Under these projections, the long-run fiscal problem in the health insurance programme is five times as serious as that in the pension programme.

Various efforts over the past decade to develop an acceptable pension reform plan have failed. In part, the failure reflects the natural tendency of the political system to postpone painful decisions about revenue increases or benefit reductions, particularly when the changes are not absolutely necessary for several decades. The failure is also in part a consequence of the emergence of a philosophical divide between those who favour maintaining the basic structure of the current system and those who want to change the basic structure by introducing advance-funded, DC accounts into the current Social Security programme.

Not surprisingly, public opinion polls suggest majorities oppose each of the three conventional approaches to closing the current financial gap. The polls are fairly consistent in their assessment of both the strength of the opposition to each approach and in the approaches' rank order. Increasing contribution rates generates the least opposition, gaining the support of approximately 40 per cent of the population. Increasing the retirement age gains the support of some 25–30 per cent of the population and reducing monthly benefits is supported by from 15–30 per cent of the population, depending on how the question is asked.[28]

A handful of conservative commentators began advocating the introduction of advance-funded, individual accounts as a replacement for all or a portion of the current Social Security system at least a quarter century ago, but the idea did not percolate into mainstream policy debates until the mid-1990s. A principal argument made for this kind of reform was that the financial markets would produce a higher return on worker contributions than was possible under the current pay-as-you-go system, thereby helping to close the financing gap without increasing taxes or reducing benefits. (Early advocates tended to ignore—or at least minimize—the cost of the transition from a pay-as-you-go to a funded system; that cost comes from the need to finance asset accumulation for current workers while continuing to pay benefits to current retirees.)

Disagreement over the role of individual accounts and of a change in the retirement age caused the failure of one of the earliest attempts to develop a concrete pension reform plan. An advisory council established by the Clinton Administration in 1994 and tasked with developing a reform proposal fractured into three camps over these questions. The largest group favoured maintaining currently scheduled benefits and financing them, in part, by investing a portion of the balance in the special account in private equities. The second largest favoured diverting about half of the current contribution rate to individual accounts and using the rest to finance a much reduced benefit that was the same, regardless

[26] The 1.92 point rate increase that would balance the programme, on average, over the next 75 years would produce a deficit in the 76th year equal to 3.5 per cent of payroll.

[27] Board of Trustees of the Federal Hospital Insurance and Federal Supplemental Medical Insurance Funds (2005). The estimates include the deficit in the hospital insurance programme and the budget expenditure needed to finance projected spending in the medical insurance and prescription drug programmes. The Hospital Insurance programme is financed in the same way as the Social Security programme. Its special account is currently projected to be exhausted in 2020.

[28] Pew Research Center (2005) and Washington Post *et al*. (2005). 'Slowing the growth of future benefits' generates less opposition than 'reducing guaranteed benefits'.

of pre-retirement earnings level. The third group favoured scaling back the current programme to what could be financed at current contribution rates and adding a system of individual accounts on top of the current system (1994–96 Advisory Council on Social Security, 1996). The latter two groups also favoured increasing the retirement age to around the age of 70 by 2085, while the first would have kept it at the age of 67 as scheduled in current law.

Both President Clinton and President Bush have floated reform ideas. The Clinton proposal involved transferring some of the general budget surplus then projected for the twenty-first century, investing part of the centrally managed fund in private equities, and creating a system of voluntary individual accounts as a supplement to the current programme. President Bush has advocated giving workers the option of diverting a portion of their current contribution into individual accounts and endorsed a particular approach to slowing the growth of future benefits, but has not made a specific reform proposal. Moreover, the last 10 years have seen a wide variety of additional proposals generated by various commissions, *ad hoc* committees, individual policy analysts, and members of Congress. The proposals and the debate they have generated have failed to produce a reform plan that is both fiscally adequate and broadly acceptable, but have served to narrow (although perhaps only temporarily) the range of options currently being discussed.

President Clinton's proposal to invest a portion of the centrally managed, special account in private equities is not under active consideration (at least at this time).[29] Opposition stems primarily from a concern about undesirable government interference in the private sector. One suspects, also, that any attempt to create a government-sponsored programme for voluntary supplementation of Social Security benefits would face strong political opposition from the financial services industry.

Few politicians will currently admit to favouring either an increase in the contribution rate or an increase in the retirement age, although some individual analysts and *ad hoc* groups have endorsed one or both. There does seem to be receptivity, however, to making the whole system somewhat more progressive. In public opinion polls, majorities support increasing the ceiling on annual taxable earnings and reducing the benefits paid to the highest earners. President Bush has also endorsed both changes.

Taken by themselves, however, the fiscal impact of the two changes may not be all that great. As noted earlier, the ceiling already captures 85 per cent of earnings in employment covered by the programme. The change most frequently proposed is to increase the ceiling gradually until it captures 90 per cent of covered earnings, which would increase revenues by about 6 per cent. Nor is there much to be gained from reducing benefits to the highest earners, unless benefits to average and below-average earners are also reduced. Recall that the average Social Security benefit received by those in the highest income quintile is not all that much higher than the average received by those in the 2nd quintile. Converting the system to one that capped benefits at the level currently paid to the middle-income quintile would not come close to producing the savings needed to balance the programme in the long run.

President Bush did once voice support for a particular proposal that would have preserved scheduled benefits for low earners while reducing them for high earners. The benefit reductions in the proposal he endorsed would have been large enough to produce long-run financial balance, but they would have also reduced the benefit of the hypothetical average earner by 30 per cent between now and 2080. That proposal has found almost no support among members of Congress.

Recently, most attention has been focused on how an individual account programme would be structured, should such a programme be adopted. Virtually all current proposals make participation voluntary because opinion polling and political soundings have found significant opposition to mandating participation. Most current plans finance the accounts by diverting (or 'carving out') a portion of the current contribution rate because most of the advocates of this kind of reform have a general preference for minimizing the size of government and therefore oppose any increase in the total contribution rate. Since the total contribution rate for retire-

[29] This, however, is an important element of the long-range financing plan recently adopted by our northern neighbour, Canada.

ment and survivor benefits is only 10.6 per cent, the amount that can be carved out for this purpose is rather limited. Many proposals call for diverting just 2 percentage points of the current contribution rate.

Most current proposals also call for central management of the individual accounts by a government agency. Participants could invest their account balances in a relatively limited number (5–10) of stock and/or bond funds, each of which had a portfolio matched to a broad market index. Private asset-management companies would manage the investments, but the government agency would keep track of each worker's account. Upon retirement, the regular Social Security benefit of participating workers would be reduced by an amount somehow related to the amount of the diverted contributions.

Central management of the system is dictated by the need to minimize the cost of maintaining a large number of relatively small accounts. With a 2 per cent contribution rate, the average annual deposit in the account would be less than the minimum amounts required to open an IRA at most private-sector financial institutions. Private management of the funds through accounts linked to market indices is designed to prevent the government from using these funds to influence private business decisions.

This institutional arrangement mimics that of the Federal Thrift Savings Plan (TSP), a very successful programme that the federal government set up in the mid-1980s to give its own employees access to a retirement savings plan similar to the 401(k) plans in the private sector. The TSP offers participants a choice of seven indexed funds, each managed by a private investment manager to match a market index calculated by a different private entity. The plan currently manages over $100 billion at an annual cost of about 0.05 per cent of assets. Whether a similar agency maintaining accounts for millions of workers in the private sector would be nearly as cost-effective is a matter of current controversy.

If participation is to be voluntary and financing is to be through a carve-out, a mechanism is needed for reducing the value of the traditional Social Security benefit for those workers electing to participate. The approach used in most current proposals is to reduce a participant's traditional Social Security benefit by the actuarial equivalent of the balance that would be in the worker's account if diverted contributions had been invested entirely in government bonds. In effect, workers are borrowing at the government bond rate, investing the proceeds in the financial markets, and then paying off the loan (with interest) at retirement. Two drawbacks to this approach are that it increases benefit variability and will make more obvious those cases where the individual would have been better off not participating.

It is not clear how easy it would be to implement this kind of Social Security reform. Even the advocates admit they do not know how to handle cases where a worker dies or becomes disabled before reaching retirement age. Moreover, 'actuarial equivalence' is likely to be easier to define in theory than to calculate in practice. The actual calculation would have to deal with a variety of supplemental benefit entitlements found in the current programme.[30] It would also require various assumptions about future demographic and economic trends (notably, future inflation rates) that will prove to be wrong shortly after the benefit adjustment has been calculated.[31]

At the time of writing, the prospects for adopting some form of individual account, carve-out proposal are unclear, although the odds seem to be against the change. As noted, the President favours this approach. He made a significant effort to generate political support for it early in 2005, including several personal appearances each week over a period of several months at rallies around the country. The critics seem to have made the more effective case, however, as support for the general approach appears to have declined between the autumn of 2004 and the spring of 2005.[32] By the autumn of 2005,

[30] The programme offers additional benefits for family members dependent on a retired worker as well as certain former spouses, subject to a rather complicated limit on the total monthly benefit that can be paid on the basis of any one record.

[31] An alternative approach used in many earlier proposals was simply to recapture a specified fraction of the final balance, either directly or through an 'actuarial equivalent' reduction in the traditional benefit. The drawback to that approach was that the recapture rate would have to be rather high (80 per cent or more). Direct benefit offsets are necessary because the three-bracket benefit formula prevents adjustments through changes in the amount of earnings credited for benefit calculation purposes.

[32] Measuring the degree of support for these kinds of proposals is difficult, as the results of public opinion polls are quite sensitive to the way the question is asked. However, by last spring, most measures showed that a majority opposed the approach and that opponents tended to hold their views more firmly than proponents. One source reports that support fell from 58 per cent in September 2004 to 46 per cent in February 2005 (Pew Research Center, 2005).

Congressional leaders had all but abandoned efforts to develop a specific plan. Among the general public, opposition to the approach appears to centre primarily on distaste for having workers assume greater financial risk and the desire to avoid reductions in the traditional DB benefit. A number of Congressional and business leaders are also wary of the transition costs, which would likely sum to several trillion dollars over a 20- or 30-year period.

(ii) Income Adequacy

Several policy initiatives either recently undertaken or now being debated are designed to fill specific gaps in the current retirement income system. Each tends to be an *ad hoc* response targeted on a particular adequacy problem or beneficiary group. Generally, the cost and impact of each is considered individually; they are not independent elements of a comprehensive strategy.

A couple of rather modest interventions are motivated by the desire to increase participation in employer-sponsored retirement plans. One is a tax credit to encourage savings among low-income workers. The provision was adopted in 2001, but will expire at the end of 2006 if not renewed by the Congress. Under the provision, below-average earners can claim an income tax credit equal to 50 per cent of any contribution to a tax-deferred retirement savings account, such as an employer-sponsored salary reduction plan or an IRA. The credit applies to contributions up to $2,000 a year.[33] In effect, the government provides a 100 per cent match for the first $1,000 contributed to such plans by qualified households. The government's matching contribution is in addition to any employer match.

The interaction of the mathematics of the credit and the threshold below which households pay little or no income tax makes the actual impact of the credit far less dramatic than the theoretical description implies. The credit is not currently 'refundable', which means that the amount of the tax reduction that a household can actually receive is limited to its tax liability before the credit.[34] It is estimated that while 77m people are potentially eligible for the credit, only about 12m could actually benefit from it and only about 100,000 could qualify for the maximum credit (Gale *et al*., 2005). The credit is popular and is likely to be renewed. It would be much more effective if it were made refundable, so that those whose credit exceeded their tax liability would receive a rebate. Whether or not this will be done and what impact it would have on the retirement savings of lower-income households is not currently known. Given the government's current fiscal problems, a substantial increase in the cost (and value) of the credit seems rather unlikely in the near future.

A second modest intervention would encourage employers to change the way the election to participate in a salary reduction plan is handled. In the vast majority of plans, employees must make an affirmative election in order to participate in the plan. A few employers have changed their policy so that new employees are automatically enrolled in the salary reduction plan (although usually not at the maximum contribution rate) unless they elect out. The experience of these employers suggests that such a change will substantially increase the fraction of new employees that enrol in the plan.[35] Under normal circumstances, enrolment rates increase with age and job tenure, so many of these people would have enrolled in the plan eventually. Earlier enrolment produces more adequate balances owing to higher contributions and a longer accumulation period, however, which simulations suggest will help lower earners the most (Holden and VanDerhei, 2005*a*). Automatic enrolment would increase the fraction of covered workers that participate in the retirement programme, but would not help the 40 per cent of the work-force that does not currently have access to an employer-sponsored programme.

[33] Couples with incomes above $30,000 but below $50,000 are eligible for a credit of 10 or 20 per cent of any contribution. The income thresholds are lower for single individuals (see Gale *et al*., 2005).

[34] In contrast, a credit based on the level of earnings of lower-income individuals, the Earned Income Tax Credit, is refundable. Under that programme, if an individual is entitled to a credit that is larger than his or her tax liability, the government pays the individual the difference.

[35] For example, Madrian and Shea (2000) and Choi e*t al*. (2004). The legislation would insulate employers from liability for financial losses suffered by employees enrolled automatically, provided the employees are notified properly and are enrolled in relatively riskless investments.

There is concern about the low incidence of annuitization of retirement account balances. While there is no support for mandating the purchase of annuities, there is discussion of using tax credits or deductions to encourage their purchase.[36]

In recent years, public policy debates linked to benefit adequacy have focused not on income levels and distribution as such, but rather on the affordability of essential services, particularly health care. One health financing issue likely to be a continuing public-policy issue is the new prescription drug insurance programme. The structure of benefits under that programme is likely to prove politically unstable and require further adjustments.

As enacted, the new benefit must cover 75 per cent of the cost of the first $2,000 in prescription drug expenditures (after a $250 deductible) and 95 per cent of the costs of expenditures in excess of $5,100, but expenditures between $2,250 and $5,100 need not be covered. The reimbursement structure is the product of balancing competing desires to help as many people as possible cover the cost of routine prescription drugs, protect them from catastrophic expenses, and satisfy a budget constraint. The structure is likely not to look quite as logical from the perspective of beneficiaries as from the perspective of budget and policy analysts and will probably generate considerable pressure for expansion of the programme to eliminate this 'doughnut hole' shortly after the new benefit becomes effective.

V. CONCLUSIONS AND FUTURE PROSPECTS

The income projections described here suggest gradual erosion in the relative income of all but the wealthiest segment of the aged population, largely due to a decline in Social Security and private DB pension incomes that is not offset by significant increases in other sources of retirement income. Long-range projections of the Social Security and Medicare programmes suggest, moreover, that average earners will find rising Medicare premiums and other out-of-pocket health-care expenses are offsetting virtually all of the real growth in Social Security retirement benefits (Thompson, 2005). If these projections prove reasonably accurate, protecting the economic status of the aged will be a continuing focus of public policy in the years to come.

Absent a major shift in the political paradigm, policies to improve protection for the aged will probably consist primarily of continuing efforts to improve coverage of both employer-based and individual retirement savings programmes and to cushion the effect of rising health costs. As far as the retirement income system is concerned, the likeliest outcome over the next few years will be further liberalization of the limits for contributions to IRAs and salary reduction plans along with an expansion of the savers credit or the creation of some other subsidy strategy. There could even be a new programme of government-subsidized (for low-income people), supplemental retirement savings plans, if the President's Social Security reform continues to falter. If such a new plan does not emerge, and if someone can think of a public policy that could further encourage small employers to offer retirement savings programmes, short of a direct subsidy, that may also be adopted. Given the tenuous fiscal position of the federal government, none of the changes is likely to be very dramatic and their impact on future income adequacy is likely to be equally modest. At the same time, one should not expect to see any new mandates to improve economic protection, either on employers to offer salary reduction plans or on individuals to annuitize all or a portion of their retirement accounts.

The more dramatic changes in the immediate future are likely to be in health financing arrangements. The 'doughnut hole' in the coverage of the new prescription drug benefit is likely to generate pressure for programme expansion. A separate medical assistance programme pays the Medicare premiums for the low-income aged. Since premiums in the future are almost guaranteed to rise more rapidly than the cash benefits from which they are paid, one can expect pressure for further changes to reduce the burden of these premiums, at least on middle-

[36] Most of the Social Security individual account proposals include some form of annuity mandate, but it is applicable only to the balances generated from the diverted contributions. Some proposals require annuity purchase only to the extent needed to guarantee a specific level of income.

and lower-income households. If a political paradigm shift does occur, it is probably more likely to occur in health financing than in income security, since pressures for a major structural change are building on several fronts simultaneously.[37] Fortunately, speculating about when and what changes may occur is outside the scope of this paper.

Both the Social Security and Hospital Insurance programmes face serious long-range financing shortfalls, and the general budget subsidies that will be required to maintain benefits in the rest of the Medicare programme are projected to grow substantially faster than the economy. As noted, at the time this is being written, debate over reform of the Social Security programme has stalled. Also, at present there is very little discussion of how the financial problems of the Medicare programme might be addressed—largely, one presumes, for lack of credible suggestions for acceptable alternatives.

Absent the paradigm shift alluded to previously, the odds of a major reform in the near future in either the Social Security or Medicare programmes appear slight. A financial crisis in the Hospital Insurance programme appears at least a decade away and the crisis in Social Security is even farther in the future. Although all would agree that desirable reforms in either programme should be enacted as soon as possible, most also believe that, as long as benefits can continue to be paid, having no reform is better than agreeing to (what they consider to be) an undesirable reform. Also, at least with respect to the Social Security programme, time is on the side of those who prefer closing the gap through revenue increases, as these can be implemented much more rapidly than can benefit reductions.

Particularly with respect to Social Security, the recent debate over individual accounts appears to have poisoned the political well rather effectively. It is likely that no serious discussions will take place at least until a new administration takes office, and even then it is not clear what the various parties would talk about. It may be possible to develop a package with increases in the taxable ceiling and reductions in the benefits of only the highest earners that has the potential to garner majority support, but, absent some more dramatic additional changes, the package would probably fall well short of closing the deficit now projected.

Roughly half of the long-range deficit in Social Security is attributable to the assumption of increased life spans (Thompson, 1999). The most recent projections assume that life expectancy at age 65 will increase by 20 per cent—roughly 4 years—between 2005 and 2080. It is not realistic to expect that the entire adjustment to a 4-year increase in retiree life expectancy would be through contribution rate increases, although some rate increases are likely. Part of the adjustment will also have to be through reductions in scheduled benefit payments. The current rather modest average monthly benefit under Social Security and the projection of declining relative incomes for most future retirees argue against reducing average monthly benefits below currently scheduled levels. That means that, sooner or later, there will have to be a further adjustment in the retirement age. Next time, however, the increase needs to be in both the normal retirement age and the age of first eligibility to avoid further depressing monthly benefits.

Taken together, the current surpluses, an increase in the ceiling on taxable earnings, and, perhaps, a modest reduction in benefits for the highest earners would be enough to keep the system going for half a century. That would give US policy-makers the opportunity to take the steps that must eventually be taken, but with a lead time long enough to insulate them from significant political backlash. They could legislate now increases in the retirement age and in future contribution rates the would be effective some 30 or more years in the future and that were sufficient to close the fiscal gap currently projected for the latter half of the century.

As long as the philosophical debate over programme structure continues, however, the current political process is unlikely to be able to produce such a package.

[37] For instance, the number of households without health insurance coverage is increasing; workers that do have health insurance are being asked to pay a higher fraction of the cost; the number of employers willing to help finance health care for their retirees is declining rapidly; and the costs of employer-provided health care are increasingly being viewed as placing US firms—most notably those that manufacture automobiles—at a competitive disadvantage.

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