

4 THE GREAT INVISIBLE PENSION REFORM IN THE UNITED STATES

Krzysztof Ostaszewski

Is the US bankrupt? Or to paraphrase the Oxford English Dictionary, is the United States at the end of its resources, exhausted, stripped bear, destitute, bereft, wanting in property, or wrecked in consequence of failure to pay its creditors?

LAWRENCE KOTLIKOFF

Introduction

The retirement income system in the USA combines a social insurance scheme and pension systems of federal and state governments with a multitude of private retirement systems, resulting in a structure of great complexity and diversity. The upcoming retirement of the generation of 'baby boomers' is looming. This potential major crisis of public and private finance has caused alarming prognoses, but there has been no substantial reform. How will the US economy solve this problem? This author believes that the resolution is unlikely to arrive from government, but rather will arise from the human action of individual decision-makers who have already begun the process of adjustment of their lifestyle, work and leisure behaviour in order to cope with this problem. There remain, however, many explicit and implicit interventions from government which will act as obstacles to this naturally occurring human action resolution.

The economics of social insurance

Participants of any retirement income system perceive it as either a part of the private insurance system, or as a part of a welfare system. These are dramatically different perspectives. In the context of a private insurance system, a person gives up a part of their income during their working years and purchases capital assets in order to exchange them for income in the later years of life. The individual faces great uncertainties concerning the amount of income needed in retirement and the amount of savings needed to provide it. Financial intermediaries such as insurance companies, pension plans or investment funds offer help in the process, but the uncertainties are too great even for them to fully overcome. For example, the purchasing power of retirement income is not merely a function of the amount of savings and the rate of return on them, but of the rate of inflation before and after retirement, often as far in the future as 60 years beyond the beginning of the process of retirement planning, and clearly beyond the control of private financial institutions, or individual consumers. Additionally, the later years of life are exactly the years when the consumer is most vulnerable, usually unable to work, in great need of financial stability, and facing irreversible consequences of past decisions concerning retirement planning. That vulnerability is given as the key reason for inclusion of retirement provision in welfare systems in all countries that created any form of welfare state. But the welfare state provides retirement income in a different manner from private retirement systems. The most common form of state retirement provision is so-called *social insurance*. Social insurance, as opposed to private insurance, is defined by the following features:

- the system is administered by the state, and is typically universal or nearly universal;
- benefits paid and ‘premiums’ (more precisely taxes, as they are collected by the state) are prescribed by law, not by a private contract, and may be changed any time the appropriate law is changed, even for current participants who have earned benefits and paid ‘premiums’.

One more standard feature common to social insurance is that the system is financed on a pay-as-you-go basis, which simply means that premiums collected are immediately paid out as benefits, without any accumulation of assets. This is the part of any social insurance system which is subject to most frequent criticism: that by not pre-funding the benefits the system does not allow for any real investment. In the context of this statement, ‘real’ refers to the real economy, i.e. factories, machinery or any new productive capacity, as opposed to investments in capital assets, such as stocks or bonds, which are financial investments. Of course, the funds collected by a pay-as-you-go system, while paid out nearly immediately, in the process are used by the government, and for those who consider that a productive use, the argument about the lack of real investment is unconvincing. There are, however, significant additional issues to be considered.

In fact, a pay-as-you-go system creates only an illusion of involving no asset accumulation. Participants in a social insurance system accumulate rights to benefits, which are, to them, capital assets.¹ One could describe social insurance as a system of mandatory savings constructed as follows:

¹ Though, as noted above, there is risk attached to these capital assets because the government can, at any time, change the benefits to be paid.

- every working participant’s taxes contributed to the system are invested in government bonds;
- government bonds earn interest at a rate set by law, or by a social insurance government administrator;
- upon retirement, benefits are paid to the participant from that participant’s account. But if the amount of benefit exceeds that prescribed by law, the excess is taxed at 100 per cent. If the amount is lower than the amount prescribed by law, the government subsidises the benefit to reach the desired level.

One crucial difference between the accumulation of capital assets in a private system and that in a social insurance system is the method of pricing those capital assets. The amount of income received in a private pension scheme is established based on prices of capital assets in the market. If the stock market crashes, there will be less money for benefits. If the stock market booms, benefits can be increased. On the other hand, the amount of income received from a social insurance scheme is set by law. Thus, social insurance results in government pricing of financial assets, as opposed to market pricing. Individuals are forced to participate and the return that they will receive on their contributions through the tax system is fixed by law. This results in a distortion of market signals provided by prices. Proponents of social insurance, it appears, are willing to accept such distortions in order to meet the social need for a safety net for the elderly. A further difference between private and state social insurance is that the liabilities to meet the claims of retired people on their assets built up within a social insurance system do not arise from free exchange in a market but are imposed on the next generation

of participants in the system – many of whom will be too young to vote. Furthermore, the accumulation of, and accounting for, the assets and liabilities within a social insurance system is opaque in the extreme.

Some economists, notably Martin Feldstein (1974, 1977 and 1998), have argued that social insurance systems (or, specifically, the old age social security system in the USA²) lower the savings rate. This phenomenon represents itself through:

- the *saving replacement effect*: the idea that people believe that the government is saving for them through the mandatory social security programme. Therefore, private savings are subsequently decreased since the government is already saving for people;
- *induced retirement effect*: social insurance prescribes the age of retirement, and resulting inflexibility will cause people to retire, in general, too early in relation to the market value of their human capital (i.e. ability to earn income).

But one could also envisage the situation where incentives work in the opposite direction, so that:

- participants could view unrealistically high future benefit promises as simply promises of higher future tax rates, and respond with higher precautionary savings, to be able to pay those higher future taxes; and
- participants could be forced to retire at an age higher than the one desired by them, and respond by increasing their savings

² Throughout this chapter, when the words ‘social security’ are used, they refer specifically to the US Old Age Survivors and Disability programme.

in order to be able to afford at least a partial retirement at an earlier age.

But the level of savings, while important, is not the ultimate determinant of prosperity of a nation. How those savings are put to productive use matters more. The absence of price signals in a social insurance system where capital assets are not exchanged at market value is important here. Price signals in capital markets affect the real investment decisions of businesses. For example, a firm may have a choice between building a new factory or buying another firm that already owns a similar factory. If the price of that other firm, as established by the stock market, is artificially low, investment in a new factory may be abandoned, and the gain to the firm may be a loss to the society in general, because the new productive capacity of that factory is not created. In a similar way, the absence of price signals within a social insurance system leads to inefficient resource allocation.

Prices of capital assets are also affected by the changes in the relative risks of various assets as a result of social insurance provision. Because social insurance benefits enjoy government guarantee, if they are provided at an unreasonably high level, consumers may be able to increase the riskiness of the rest of their investment portfolio without overall loss to their financial well-being. Thus a stable and generous social insurance system may appear to be beneficial to the stability of society until we consider the more speculative investments undertaken by participants in their private portfolios without proper consideration for risk.

Consumers may also respond to the social insurance incentives by altering the balance between work and leisure, or between education and work. For example, the benefit formula of social

insurance may be gamed by participants. If benefits are granted, as in the USA, based on the best 35 years of work history, with past wages indexed based on an historical wage index, the optimal strategy is to work for exactly 35 years and use the other years of life to increase earnings in those crucial 35 years: one way to do this is to acquire professional or graduate education. Thus social insurance may be one explanation for ‘qualification inflation’.

Social insurance and public choice

All of the above economic considerations are only a part of the picture, because we have still not added the public choice effects of social insurance (see, e.g., Mueller, 1989). Public choice theory studies the behaviour of voters, politicians and government officials as self-interested agents. The very existence of social insurance brings about new incentives to all participants (see also the chapter by Booth):

- Because the benefit amount is not tied to contributions paid, participants can lobby government to have the tax burden shifted to other groups, such as future generations, businesses or groups and individuals viewed as more able to carry the burden (e.g. high-income or high-net-worth individuals).
- Because benefits are granted by law, special interest groups formed by the retirees (such as AARP in the USA) can lobby the government for benefit increases, programme expansion and creation of new benefits and sub-programmes. For example, in the USA a new prescription drug benefit social insurance programme was enacted in 2005 with support from AARP.

- Special interest groups can lobby the government for benefit increases or the granting of special benefits for specific professional groups (e.g. policemen, the military or teachers). Ironically, small groups can be especially successful in such rent-seeking behaviour, especially if they are well organised, closely connected with political agents, and receive concentrated benefits paid for by costs that are widely dispersed across the general population, or borne by future generations.
- Politicians holding or seeking office can offer increases in benefits in social insurance as a method of convincing voters to choose them in the election process. This is especially effective if the mechanism of shifting the cost to future generations, or to a group of voters irrelevant to a given politician, can be exploited. The actual structure of the election process becomes crucial here, because if a decisive voting block can be convinced of receiving desired benefits at the expense of others, the elections and policy implementation following it become certain, and the only counteraction will be in the form of future economic consequences (e.g. a high level of national debt leading to reductions in future state expenditures, or even some form of insolvency of the state – for an insightful discussion of such a possibility for the USA, see Kotlikoff, 2006).

All of the lobbying activities brought about by the very nature of social insurance do not, of course, remain without response. Groups targeted for tax increases respond with their own lobbying activities (although future, yet unborn, generations have been always extremely ineffective in that activity, thus there is very

little lobbying against continual increases in public debt in most modern democracies). They can also respond by legal and illegal tax avoidance, which not only reduces government revenue and redirects human action to ineffective use, but also undermines the rule of law – that rule of law which is the foundation of all social activities, including the business activities usually targeted for the taxes needed for the welfare state.

The balance of public choice effects on the retirement system depends very much on the balance of relative sizes of incentives involved. If the cost of the social insurance system is relatively low, and the public good provided (a safety net for the elderly) visible and effectively delivered, incentives for lobbying and tax avoidance may be negligible. If, on the other hand, the benefits delivered are small and marred with bureaucratic rent-seeking and intrusion into citizens' lives (for a thorough presentation of the role of bureaucracy in public choice theory, see Niskanen, 1987), while the costs of social insurance are high (which is typically a situation in the case of bureaucratic rent-seeking), productive economic decision-makers are likely to seek ways to exit the social insurance system, or arbitrage against it, further exacerbating the system's high costs.

The heavy hand of government retirement planning

One final remark on the impact of a large, dominant system of social insurance should also be added. If retirement provision is the sole, or nearly sole, domain of the central government, this clearly leads to the creation of 'national retirement policy'. Retirement is planned by the social insurance system, with a normal retirement age, early retirement age, adjustments for retiring

at different ages, calculation of benefits based on employment history, often requiring participants to produce and document their own employment histories, with adjustments for family status, and spouse employment history, and many, many other numerous factors. All of these require a massive, sophisticated, centralised model that is trying to replace the price system of a free market. And that attempt to replace the market by a sophisticated scientific model designed by central government authority is exactly the idea termed by Friedrich Hayek (1988) the *fatal conceit*. Hayek argued that price signals are the only possible way to let each economic decision-maker communicate tacit knowledge or dispersed knowledge others, in order to solve the economic calculation problem. The idea was, of course, also presented in the debate on economic calculation by Ludwig von Mises (1920), and was at the heart of the *economic calculation problem*: the issue of whether a central government authority can calculate prices in absence of free markets.

But the central idea of Hayek's work was that people often do not like the free market system because capitalism functions as an unseen extended order, while people prefer to see immediate, visible good. The invisibility of the functioning of the free enterprise system has been the constant theme of its scholars, as illustrated, of course, by the *invisible hand* metaphor of Adam Smith (1776). Capitalism is somewhat akin to electricity or any form of energy: invisible, alien, often frightening. Yet it warms or cools our houses, cooks our food, moves us around, and enriches our lives. Hayek basically told us that it is very difficult to love capitalism, because we can't touch it.

The key claim of this chapter is that the USA has entered a *Great Invisible Pension Reform*. That reform may not be loved,

but unlike central design reforms it has a chance of producing results.

The invisible and incomprehensible hand of insurance markets

The free enterprise provision of retirement income generally lies within the domain of the insurance industry. While saving and investing can be done with the help of banks, investment companies or just directly, protection against risks of timing of retirement and protection against longevity in retirement require some form of insurance (by an insurance company, or through a pension plan). This industry is among the most distrusted, obscure and unintelligible to its customers. The retirement process itself is opaque and many consumers dread dealing with it. The attitudes of those consumers is, of course, part of the problem with Adam Smith's *invisible hand*: that it is invisible! Given that, is there any hope for the insurance industry to be helpful in resolving the retirement puzzle? Or, more generally, what is the social benefit of that industry? The answer can be derived from this simple question: in the absence of automobile insurance, would people drive less or more? The answer is less, of course. The consequence of the existence of the insurance industry is that economic decision-makers can undertake more risky activities. This means that firms and individuals can undertake more projects producing necessary economic output. But it also means that firms and individuals can assume more risks that they otherwise would.

When we create any insurance system, we need to ask ourselves honestly: if we offer people risk reduction through insurance,

what will those additional risky things that people will do be? Different retirement schemes bring about different new incentives and resulting human activities; we should have the honesty and courage to at least consider those. Steven Tyler (2008), in an EconTalk.org podcast, quotes a sentence he heard from Robert Solow concerning centrally designed plans of economics, which reached their peak of power in the USA in the 1960s: 'We never did damage to reality. We used adequate abstraction.' The inadequacy of abstractions lay in the lack of consideration for human action, and brought about the harvest of crisis in the 1970s.

We have already talked about the public choice consequences of social insurance design. But what is the moral hazard of the retirement system? The risk that pensions, annuities and other retirement products insure against is the risk of finding oneself too old to work, and yet without income to sustain life. One is fully insured against that risk if one possesses assured adequate income for the rest of one's life. And therein lies the moral hazard of retirement: that people who are able to work, and who can make a significant, valuable contribution to the society, withdraw into a life of not merely leisure, but also separation from what generally goes on in the society. The skills and the wisdom of the elderly are needed far more than we commonly assume.

The old order of central control

Most of the basic design of social insurance and private pensions worldwide was created in the late nineteenth century and the first half of the twentieth century. This approach to retirement produced generally a design in which everyone was able to retire and do no work for a significant period of their lives. Social

insurance generally prescribed a retirement age, and created incentives against retirement at any other age. In the USA, the message of counting only 35 years of employment in benefit formula is clear and understood by all workers, even those who find insurance utterly incomprehensible. Furthermore, this problem is supplemented by taxation of wages that do not earn benefits, and even punitive taxation at a certain level or income, resulting in a perception of threat of loss of benefits if one works while officially retired. Private pension plans also commonly stop accruing benefits at a certain age, or after a certain number of years of service, again producing strong incentives to stop working. Traditional retirement systems from before the reforms of the late 1970s and 1980s generally insisted that workers retire and stop working at a particular point, reflecting the earlier private paternalistic arrangements of a corporatist age.

A person who desired an increase in retirement income under those circumstances had the choice between these two clear alternatives:

- work for more years, and accept lower wages resulting from punitive taxation and possible loss of pension benefits; or
- lobby the government for pension benefit increases in social insurance, or demand through the collective bargaining process that employers increase pension benefits.

Other choices emerged more clearly in the 1980s and 1990s worldwide:

- lobby the government for lower taxes and the ability to accumulate retirement assets in an individual account, where

benefit is given not by law, but determined by the account balance; or

- lobby the government to remove disincentives to work created by pension systems.

These two additional choices seem natural and offer a socially desirable solution because they result in:

- increase in labour supply;
- better incentives to work;
- a possible increase in national savings;
- market pricing of retirement income, and more efficient allocation of capital to real investment.

But these solutions do bring with them one problem: they require the same economic agents who want to work, and most likely work long hours already, to simultaneously lobby the government and be involved in the political process. Only a deep crisis, such as the one of the late 1970s, could bring about enough will to encourage such people, who have a high marginal utility of time, to involve themselves with the political process.

The USA never created a dominant national pension system. The American retirement system currently in existence is extremely complex, because it consists of many 'moving parts' that interact with each other (that is, various forms of retirement income provision, public and private, affect each other). In the first half of the twentieth century, pension system design was mostly centralised. In 1935 the federal government created the social security system, a universal social insurance retirement system, which, by welfare state standards, is relatively

small, aiming to replace, on average, approximately a quarter of pre-retirement income. Employment-based pension plans, while in existence before World War II, became a significant factor in the national economy during that war, as labour unions lobbied employers and government for benefit increases in lieu of wage increases, while regular wages and prices were subjected to government controls. Pensions granted by social security and employers were of a defined-benefit type, and their design included strong incentives to retire upon reaching normal retirement age. But, in addition to those command economy aspects, the US economy also contained a large and established insurance industry offering retirement annuities, as well as an active private investment industry, and a private real estate market, with relatively easy access to long-term mortgage loans at fixed interest rates. There were also some defined contribution pension plans. All of these offered either opportunities for private wealth accumulation or insurance against retirement risk. Additionally, workers in large parts of the US economy were not covered by social insurance or employment-based pensions. Nearly half of workers were initially not covered by social security, including self-employed individuals, as well as employees of states and cities – though state and city employees were generally covered by pension plans created by their employers.

Proposals to promote the ‘invisible hand’

Dramatic changes to the old system started in the 1970s. In 1974 the Employee Retirement Income Security Act was implemented. The law created strict funding requirements for private defined-benefit pension plans, and created Individual Retirement

Accounts. In 1978, Congress amended the Internal Revenue Code, in Section 401(k), allowing employees not to be taxed on income they choose to receive as deferred compensation rather than direct compensation. This started 401(k) accounts, the most popular type of employment-based defined-contribution pensions. In the early 1980s, the financial projections of the Social Security Administration indicated near-term revenue from payroll taxes would not be sufficient to fully fund near-term benefits. The US government appointed the Greenspan Commission, headed by Alan Greenspan (before he became chairman of the Federal Reserve), to investigate what changes to federal law were necessary to shore up the social security programme. The adjustment to the structure of social security recommended by the Commission involved the following elements: some tax increases; substantial benefit cuts; an increase in the normal retirement age; expansion of coverage of workers to near universal; and creation of a trust fund. This was the last major reform of US social security.

Since then, there has been political stalemate about the system’s status. When the second term of President Reagan ended, social security was in a short-term and long-term surplus. This changed following the 1991 recession, and the system has remained in long-term actuarial deficit since. In 1994 the situation was judged to be so grave that an Advisory Council was appointed to address the issue. The Report of the 1994–1996 Advisory Council on Social Security outlined three options for social security reform:

- The first option sought to maintain the then current system’s basic benefit structure by increasing revenues and reducing outlays. Specifically, the plan sought to increase programme

revenues by extending coverage to state and local government employees hired after 1997, extending and increasing the taxation of benefits to all recipients, and increasing the payroll tax by a combined 1.6 per cent. The plan also called for an extension of the benefit computation period from 35 to 38 years by 1999, thereby reducing benefits by an average of 3 per cent. Since these revenue and expenditure measures did not completely solve the long-term solvency problem, the proposal recommended investing up to 40 per cent of the trust fund in the stock market.

- The second option sought to restore programme solvency mainly through reductions in outlays. Such reductions were to be achieved by accelerating the increase in the retirement age to 67 by 2011 and to 70 by 2083, reducing the growth of basic benefits, and extending the benefit computation period. This option would also establish a system of mandatory individual accounts to be funded by employee contributions. Specifically, workers would be required to contribute an additional 1.6 per cent of covered earnings into a personal savings account. Individuals would have limited choices on how these accounts would be invested.
- The third option was to replace the current social security system with a new two-tiered system. The first tier would provide a flat-rate benefit based on a worker's length of service. Workers with 35 or more years of covered employment would receive a monthly benefit equal to 65 per cent of the current poverty level. The second tier would supplement this basic benefit by creating a system of Personal Saving Accounts funded by 5 percentage points of the 6.2 per cent payroll tax on employees. These accounts would be

individually owned and managed. Workers would be able to invest in a wide range of investment options.

These proposals were produced by different groups of the Council, and represented mutually incompatible options. Generally, the first option was supported by the Democrats, and the third by Republicans, although this party association was not universal. The resulting stalemate has lasted since the 1997 publication of the proposals, even though President Bush's election platform included a proposal similar to the third one. The long-term solvency of social security remains a problem. This, in combination with future costs of healthcare provided by the US government (through Medicare social insurance and Medicaid social assistance) and public debt, is the reason why Kotlikoff (2006) raised the possibility of US bankruptcy.

The invisible hand needs no help from government

But while the social insurance status has been deteriorating, the other parts of the US pension system have been performing rather well. The amount of assets held to meet retirement needs, as given by EBRI (2007), increased from \$2.4 billion in 1985 to \$14.4 billion in 2005. The growth has been particularly dramatic among plans that have a more individualist nature – specifically defined-contribution arrangements and Individual Retirement Accounts. Within this period, both the federal government and other types of government (state and local) have added and expanded defined-contribution plans. While social security reform creating individual accounts stalled, individual accounts prevailed in the marketplace. Notably, Individual Retirement Accounts (IRAs),

non-existent in 1973, and funded sometimes with funds that do not qualify for tax relief, now constitute nearly a quarter of all retirement assets in the USA.

The mid-1990s was an ideal time for a resolution of the baby boomers' retirement puzzle. That generation was still at least ten years from retirement, so there was time for them to act and prepare. The failure of the federal government to reform social security was accompanied by failure to stop dangerous long-term trends in Medicare and Medicaid, and rising healthcare expenditures in general. But that was also the time when the trend towards individual accounts accelerated. Furthermore, that was the time when labour participation rates for older Americans started climbing. The percentage of civilian non-institutionalised Americans aged 55 or older who were in the labour force declined from 34.6 per cent in 1975 to 29.4 per cent in 1993. Since 1993, however, the labour-force participation rate has steadily increased, reaching 38.0 per cent in 2006 – the highest level over the 1975–2006 period.

We should also note that at that time the following two additional phenomena occurred (see Hutchens, 2007):

- phased retirement: the situation in which workers gradually decrease the number of hours worked, while beginning to receive their pension benefits, and possibly accruing defined-contribution plan balances; and
- accommodation of such phased retirement by state and city governments, which had previously used traditional incentives for early retirement, by creating systems of *re-employment of retired employees*, who do not accrue new defined-benefit pensions by working, but can accumulate defined-contribution plan balances.

At the same time Muldoon and Kopcke (2008) point out that a very large percentage of workers in the USA claim their social security benefits at the earliest possible age: 62. This means that workers seek minimum income protection from the federal government, but are not very eager to postpone receiving that minimum in return for social insurance benefit increases. The political stalemate in the reform process resulted in workers taking what they can get from social insurance and then working longer and accumulating money in defined-contribution plans in order to fully resolve the retirement puzzle.

We can see that all of the moving parts of the US retirement systems affect each other. One more example of that is the work of Friedberg and Webb (2005). Analysing data from the longitudinal Health and Retirement Study, they concluded that defined-contribution plans lead to an increase in the retirement age of nearly two years, on average, compared with defined benefit plans. Moreover, the authors suggest that their findings may explain the recent increase in employment rates among people in their sixties, following decades of decline. They expect this trend to continue, as more workers with defined-contribution plans reach retirement age and defined-benefit plans become largely a thing of the past.

Political stalemate and human action

There are common threads in the Invisible Pension Reform in the USA:

- The federal government has instituted changes in social insurance. Normal retirement age in social insurance was increased, but Medicare eligibility age remained unchanged,

and Medicare coverage was expanded. Medicare benefits can be received even while a person still works. Some reductions in benefits for working while receiving social insurance were removed. All of these spell out the message that workers should claim all social insurance benefits they can as early as possible, but continue working, full time or part time, if they can.

- Since social insurance benefits are not fully indexed to inflation, and decline in purchasing power in relation to the cost of healthcare, a major service needed by retirees, this also pushes retirees to work to supplement their income.
- State and city employees' pension plans have become very accommodating about employees receiving pensions but returning to work.
- A significant move from defined-benefit (DB) plans to defined-contribution (DC) plans, or individual accounts in general, resulted in significant incentives for working longer, as both disincentives for work in DB plans are removed, and incentives to work in DC plans are introduced.
- The trends towards working longer and towards individual accounts reinforce each other.
- While the health insurance market in the USA remains very inflexible, with health insurance tied to employment, the social health insurance for retirees, Medicare, increased its flexibility, by expanding benefits and allowing options to purchase private coverage, either replacing regular social insurance or supplementing it. The labour market in the USA is relatively flexible, but the health insurance tie-in to employment is its major inflexibility. This is not the case for retirees, as social insurance health coverage is available for them.

Thus, it can be argued that the retirement crisis in the USA is solved, albeit without major fanfares and political action. Instead, human action reform is implemented, with the key features being workers relying on support from social insurance at only a low level because they are willing to bear the cost of retirement that is not paid for by social insurance and employment-based pensions, by working longer and accumulating wealth in individual accounts.

It should also be added that the continuing process of transition from DB plans to DC plans has been greatly misrepresented. It is not a transition from one form of pension to another, but a transition to more freedom for the retiree. DB plans may be desirable, but have been captured by political interest groups, and serve the purpose of regulating retirement age, regulating years of employment, regulating union membership and (in the case of social insurance DB plans) redistribution of income. The DB product cannot be purchased in an open market, but rather it comes in a tie-in transaction, with all the regulatory burdens imposed by government, and the move to DC may be, at least partly, in response to the undesirability of that tie-in.

Future reform

It can be seen, therefore, that the Invisible Pension Reform in the USA amounts to a reduction in the relative size of that part of the retirement system under significant government control, and expansion of the part functioning in a relatively free market. Reform proposals should embrace those trends. In particular, the following proposals should be adopted:

- All restrictions on employment of recipients of social security should be removed. To pay for the possible cost of this, future benefit increases earned by such employment activities can be reduced, simultaneously helping the financial standing of social security and increasing incentives to work.
- Regulation surrounding the design of individual accounts used for retirement should be simplified. There are many types of plans with individual accounts in the USA, and workers often do not understand their significance and relationships. One possible reform could be that a worker could have their defined-contribution plan funds placed in an employment-based account or in an Individual Retirement Account with completely equivalent tax treatment of the two transactions. The objective should be for all workers to have large and economically significant Individual Retirement Accounts.
- The final and key step should be to cut benefits in the social security system enough to make it financially sound again, while allowing the system of individual accounts to expand. The simplest means of achieving this would be to cut benefits in exchange for workers having a portion of their payroll taxes contributed to a Roth Individual Retirement Account (Roth IRAs receive the same tax treatment as originally designed social security benefits). If the cut is larger in actuarial present value than the funds contributed to Roth IRAs, the social security system will benefit, but workers will gain the freedom of having the desirable individual account.

Problem solved?

In conclusion, the pension crisis in the USA is currently being actively resolved, but only at the level of individual human action, not at the level of political human design. The big question is not: 'What can the government do to resolve the crisis?', but rather: 'What can the government do to not harm this naturally occurring resolution?' People work more and lobby less, at least in the context of their retirement income, if private arrangements are dominant. We should welcome and embrace that. If a political resolution is put forth, the key question to ask is: 'What lobbying groups will it create and why?' But we firmly believe that American people have found a way to tackle their retirement problem, and we should trust their actions.

No, the USA is not bankrupt: but it has some work to do.

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