

In Brief: Social Security Financing: Automatic Adjustments to Restore Solvency

Many countries are facing social security solvency problems as longevity and the number of years that retirees collect benefits increase and birthrates fall. A growing number of countries are adopting automatic mechanisms to improve solvency, rather than changing taxes or benefits in an ad hoc manner. Automatic adjustment mechanisms eliminate the need for large program changes made in crisis mode, and may be more politically feasible than ad hoc changes. The experience of the 12 countries discussed in this paper provides insights on the range of design features of auto-stabilization mechanisms and what their effects might be if implemented in the U.S.

Automatic Mechanisms

This report examines the experience of 12 countries that use automatic adjustment mechanisms to restore and maintain the solvency of their social security systems. Automatic adjustments can involve increases in tax rates, benefit cuts, or changes in the early and normal retirement ages. Automatic adjustment mechanisms change the social security program parameters depending on economic and demographic developments and the financing status of social security programs. For example, these policies decide in advance that if life expectancy or the ratio of retirees to workers increases, or the rate of wage growth decreases, what program changes will be made to maintain adequate financing.

One reason that social security systems in a number of countries are not solvent is that retirees are living longer and spending more years collecting benefits relative to the number of years spent

working. Thus one way to improve solvency is to increase taxes or reduce benefits when life expectancy increases.

Country Experience

Portugal implemented life expectancy indexing in 2008; **Finland** and **Norway** are scheduled to do so in 2010. **Poland** effectively indexes benefits for life expectancy by using life expectancy at age 62 to convert notional account balances into an annuity. **Italy** plans such adjustments, but they are not fully automatic, and thus far planned adjustments have not been approved.

The **United Kingdom** links the eligibility age for future retirees to projected increases in life expectancy. By using projected life expectancy, the UK approach gives workers at least 15 years advance notice of changes in the eligibility age. **Denmark** is increasing its early and normal eligibility ages in stages, after which they will be indexed to increases in life expectancy.

Sweden uses life expectancy indexing and the automatic adjustment of benefits. It also has an automatic balancing mechanism to further ensure solvency, and although its use has not yet been required, these mechanisms appear to be well-accepted. **Germany** incorporates life expectancy and other variables into a more complex adjustment to both benefits and taxes. However, the German government overrode automatic adjustments due in 2008 and 2009. **Japan** has incorporated features of the Swedish and German systems into its approach, implemented in 2004.

In the U.S., initial benefits at retirement are designed to grow with the growth rate of real wages in the economy. Because of automatic adjustments, in Sweden initial benefits at retirement grow at the growth rate of average wages minus an adjustment for the increase in life expectancy. In Japan, the average benefit level grows at the growth rate of average wages less the growth rate in life expectancy.

Canada introduced an automatic adjustment mechanism in 1997. If a triennial evaluation indicates that the system is not sustainable and the provincial finance ministers cannot agree on an adjustment, then benefits and taxes are automatically adjusted.

Beginning in 2009, **France** will increase the number of years of service needed to receive full benefits, and from 2013 through 2020, the required years of contribution will be increased to maintain a constant ratio of contribution period to average length of retirement. This is effectively a form of life expectancy indexation of benefits.

Design Issues and Implications

Life expectancy indexing benefits results in a decline in the portion of wages replaced by benefits. This can be offset by increasing revenues, by raising the retirement age, or by people choosing to work longer. Policies can also be implemented to mitigate the effects of life expectancy indexing on low-income persons and persons who are unable to extend their working lives.

Automatic adjustment mechanisms can eliminate the need for large program changes made in crisis mode. They can eliminate the risk of insufficient financing. Automatic mechanisms offer some certainty for workers and retirees, because it is known in advance how taxes and benefits will change if solvency deteriorates. For automatic indexing to work, it must be supported by a broad-based political commitment not to seek vote-winning modifications that undermine its effectiveness. It appears likely that the automatic adjustment mechanisms will work in Sweden and Japan because of the consensus nature of their politics. Italy and Germany have already overridden automatic adjustments.

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