Mr. Chairman, Senator Moynihan, and other members of the Committee, thank you for this opportunity to testify.

Introduction

The nation is about to experience an enormous demographic shock. Between 2010 and 2030, the over-65 population will rise by 70 percent while the labor force will rise by only 4 percent. (See Charts 1 and 2.) The Congressional Budget Office (CBO) projects that Social Security benefits will be absorbing 2 percentage points more of the GDP by 2030 while Medicare and Medicaid will be absorbing 6 percentage points more by 2040. (See Chart 3.)

Estimates of this type and the projections of the social security actuaries assume that the productivity of workers continues to rise at rates similar to those experienced over the past 40 years, even while the economy is enduring this massive shock. If the economy slows in response to the demographic changes, programs for the elderly will become much more burdensome than usually implied and it becomes even more urgent to undertake reforms.

CBO has done some simulations in which growing public deficits soak up private saving thus leaving less capital to enhance worker productivity. The economy thus slows and further increases deficits, slowing growth further, etc., until the whole economy collapses into nothingness.

Such projections are useful in that they dramatize the risks that we face, but they are unrealistic in that they assume that neither the public nor the private sector changes policies in response to the looming disaster. Herbert Stein has said that something that cannot go on forever will stop. The interesting question is how it stops and how much pain is associated with putting on the brakes.

In any case, it is vitally important to preserve a decent rate of economic growth as the retirement of the baby boomers approaches. Presuming that we do not start eating into our seed corn, the only resources available for workers continues to rise at rates similar to those experienced over the past 40 years, even while the economy is enduring this massive shock. If the economy slows in response to the demographic changes, programs for the elderly will become much more burdensome than usually implied and it becomes even more urgent to undertake reforms.

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Addressing the Shortage of Labor

When the baby boomers begin retiring in large numbers around 2010, it is important to induce older workers to remain in the labor force. These same demographic trends also have important private sector implications that have not been analyzed as thoroughly. Most important, the private sector will experience a major loss of experienced workers as large waves of baby boomers retire.

There is also a danger of a severe shortage of savings to finance the capital formation that we need to maintain the growth of worker productivity. Private pension plans are now an important source of saving. As baby boomers retire, net contributions to pensions will decline and there is the possibility of net withdrawals by 2020.1

At the same time, Government may be borrowing more private savings to finance the growing deficits that result from rapidly rising Social Security and health benefits. In addition, it will be more difficult to make up for our savings shortfall by borrowing from abroad. Almost all developed countries will be facing the same demographic problems, and in some, such as Japan, the problem comes sooner and is much more severe. (See Chart 4)
When the baby boomers begin retiring in large numbers around 2010, it is important to induce older workers to work longer. That will not be easy, because it flies in the face of a strong trend for workers to retire earlier and earlier. (See Chart 5) In part, earlier retirement is a natural response to rising standards of living. As people become more affluent, they are inclined to want to enjoy more leisure time.

However, the trend toward earlier retirement is also encouraged by numerous private and public incentives. The private sector has encouraged early retirement in recent decades for a number of reasons. First, the cost of health benefits soars as workers age. Second, there has been a desire to make room at the top as the bulge of baby boomers was working its way up the career ladder. Third, it is contractually and morally difficult to cut pay as productivity declines with advancing years, and it is not worth it to retain older workers at the compensation levels associated with the top of their career. Fourth, the pursuit of productivity gains has become almost frantic in American business as foreign competition has intensified and pricing power has waned. This has provoked downsizing and often, older workers are the first to go.

For these reasons, employers have not made much of an effort to encourage later retirement. Defined benefit plans typically do not provide a significant reward for longer work and some employers actually pay older workers to retire early. Also, it is usually difficult to arrange to stay on one's career job on a part-time basis at a lower rate of compensation. Public incentives to retire early provide strong reinforcement to private incentives. The reward for working longer under Social Security is not quite actuarially fair, and there is some evidence that it is not well understood in any case. In contrast, the retirement or earnings test is very well understood and combined with the tax system, it can be highly punitive toward work. The very existence of Medicare makes it less necessary to work longer, and in addition, Medicare is not the primary payer when workers are covered by an employer-provided policy. This further encourages employers to shed older workers.

I was a member of the CSIS Commission on Retirement Policy, which tackled some of these issues. It suggested public sector reforms, such as increasing normal and early retirement ages under Social Security, but I gather that Senator Breaux, a co-chairman of the Commission, will be explaining the proposals in detail at some later time.

Focusing here on the threat to economic growth posed by future labor shortages, the main question is whether the private sector will adapt and begin to reverse the practices that promote early retirement. They will certainly have an incentive to do so and the free market usually responds well to incentives. If public incentives are changed in a way that complements changes in private incentives, the effects could be substantial. It is interesting to note that in 1950, when incentives to retire were much weaker, the average age at which Social Security benefits were claimed was greater than 68, even though life expectancy at age 65 was much shorter and health was less robust. Today the average age at which benefits are claimed is less than 64. This suggests that there is much scope for inducing longer work. However, one would feel more confident if one heard more discussion of the problem in the private sector.

**Coping with a Shortage of Capital**

The most reliable means of leaving extra savings and capital to future generations is to continue to run a budget surplus. The resulting retirement of the national debt makes financing available to the private sector for investment in the machinery and structures necessary to enhance the rate of growth of worker productivity. True, some of the extra financing will simply reduce the extent to which we have to borrow from abroad, but that also raises future American incomes by reducing the future flow of interest and dividends abroad.

Reducing the debt has the added advantage that it will reduce the future interest burden facing the budget. This means that programs, such as Social Security and Medicare, will not have to be reduced as significantly and/or tax burdens will not have to be increased as much. In addition, having a surplus makes it much easier to contemplate a Social Security reform that includes individual saving accounts. At the time of the reform, the existence of a surplus allows for tax cuts that ease the burden placed on current workers by the need to contribute both to the benefits of current retirees and to their own retirement accounts.

In addition to paying down the debt, it is important to make our tax system less hostile to saving and investing. I have long favored radical reforms that would reduce the tax burden on saving and investing and increase the burden on consumption, but it is very difficult to get there from here, both technically and politically. Less ambitious reforms would simplify and expand IRAs and other vehicles that attempt to encourage savings, eliminate or reduce the burden of the alternative minimum taxes on individuals and corporations, and consider reducing the double burden on dividends resulting from corporate and personal income taxes.

Most of the saving in our economy is done by the most affluent and therefore, tax measures that favor saving are likely to reduce the progressivity of the tax system. If this is deemed objectionable, an adjustment can be made to marginal tax rates. The Congress is often reluctant to raise marginal rates explicitly, but it should be noted that we have often done it implicitly in recent years with phase-outs of the child and education credits and of various types of IRAs.

When considering tax reforms, it is not only important to reduce the burden on saving and investing, it is also important to treat different types of saving and investing more equally so that we utilize our saving and capital stock more efficiently. That is to say, we should allow the market to determine where our saving is invested instead of having the allocation distorted by the tax system. This is a major reason that I earlier mentioned reducing or eliminating the personal and corporate alternative minimum taxes. They can be totally arbitrary in the way that they affect different types of saving and investment.
Tax reforms aimed at enhancing saving will be most effective if they are done in a surplus neutral manner. Otherwise, the elimination of a disincentive is only advisable if the positive effect on private saving is greater than the negative effect on the budget surplus. This is a high standard to satisfy and many economists do not think that saving incentives, such as IRAs, pass the test. I happen to be on the other side of that argument, but this does not deny the fact that the reform will be more effective if done in a surplus neutral fashion.

**Conclusion**

There has been much discussion of the effect of the retirement of the baby boomers and longer life expectancies on the future budget burden imposed by Social Security, Medicare, and Medicaid. There has been much less discussion of the impact on the private sector as vast numbers of experienced workers retire from the labor force and capital becomes scarce because of reduced saving in pension funds and other factors. These private sector impacts threaten to diminish the rate of economic growth below the levels assumed in common budget projections. If this happens, it will be necessary to cut benefits to a greater extent than is now contemplated or to raise revenues by a greater amount.

As the nation contemplates reforms in the benefit and tax system, it is necessary to keep in mind the importance of encouraging growth by reducing impediments to working longer and saving more. Increasing the size of the pie in the future is the one sure way of improving the prospects of both the retired and working populations.

**Charts**

**Chart 1: BABY BUST, BABY BOOM, BABY BUST**

*The total fertility rate for any year is the average number of children who would be born to a woman in her lifetime, if she were to experience the birthrates by age, observed or assumed, for the selected year, and if she were to survive the entire child-bearing period.*

Chart 2: SOCIAL SECURITY BENEFICIARIES PER WORKER GROW

Chart 3: PROJECTED FEDERAL BUDGET OUTLAYS FOR SOCIAL SECURITY (OASDI) AND MEDICARE (HI + SMI)

Chart 4: IMPACT OF AGING POPULATIONS IN G-5 COUNTRIES

Note: The aged dependency rate is the ratio of the number of persons over age 64 to the number of persons aged 15 to 64.

Chart 5: INDIVIDUALS RETIRE EARLIER: AVERAGE AGE AT WHICH MALE WORKERS BEGIN RECEIVING SOCIAL SECURITY BENEFITS


Notes

Other Publications by the Authors
- Rudolph G. Penner

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