

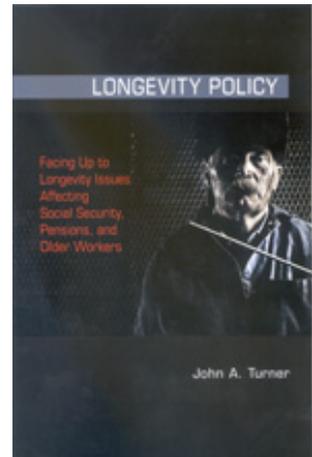
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# The Policy Challenges of Increasing Longevity: Paying the Costs of Living Longer

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**Longevity Policy: Facing Up to Longevity Issues Affecting Social Security, Pensions, and Older Workers**

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# 1

## **The Policy Challenges of Increasing Longevity**

### **Paying the Costs of Living Longer**

Increases in life expectancy are no secret, yet government policy does not explicitly deal with their well-known consequences for Social Security financing. Every day 12,000 baby boomers turn 50. Continuing improvements in life expectancy mean that those people will live longer on average than any previous generation. That fortunate development, however, poses public policy challenges as to how to pay for the living costs of those added years.

This book focuses on public policy issues concerning Social Security, pensions, and older workers that arise because people are living longer. The question it addresses is, “What should be the retirement policy responses to increased longevity?” Not only has increased longevity occurred for all major demographic groups, but people are healthier at older ages. This book draws on international experience to recommend solutions for U.S. policy.

The premise of the book is that public policy should recognize longevity policy as a distinct area—as we do now, for example, for climate change. The reason longevity policy is best treated as a unified policy area is that the challenges arising from increased longevity are best dealt with when the interrelationships between work at older ages, Social Security, and pensions are recognized. Rather than separately treating the issues raised by life expectancy in policies toward older workers, and in other unrelated policies concerning Social Security and pensions, a unified approach toward policies concerning Social Security, pensions, and work at older ages would facilitate making needed changes in each of the areas. Because of interconnections between these three areas, policy will be more effective if it considers them together, rather than separately. Furthermore, the book argues that policy should be developed that is directly related to the effects of increasing life expectancy.

Social Security is projected to have insufficient funding to pay promised benefits on time. The 2010 report of the trustees of Social Security projects that Social Security will not have sufficient resources to pay benefits on time starting in 2037, at which point it will be able to pay 75 percent of promised benefits. The annual cost of Social Security benefits represented 4.8 percent of GDP in 2009 and is projected to increase gradually to 6.1 percent of GDP in 2035 and then decline to about 5.9 percent of GDP by 2050 and remain at about that level. The projected 75-year actuarial deficit for the combined Old-Age and Survivors Insurance and Disability Insurance (OASI and DI) Trust Funds is 1.92 percent of taxable payroll (Social Security Board of Trustees 2010).

When Social Security is reformed to deal with its financing insufficiency, the effects of the changes will depend on whether employers and workers extend work at older ages and what changes are made to pensions provided by employers. Features of Social Security affect when people retire, but so do pensions and labor market conditions. Living longer affects all three areas, so that policy dealing with greater life expectancy should address all three areas at the same time.

Many of our social policies and employee benefit policies were designed for an era when people had shorter lives. With the demographic changes occurring, it is time to reexamine those policies so that they fit the realities of the new demographic era of living longer.

## **LIFE-EXPECTANCY INCREASES**

### **Overall Gains and Distributional Issues**

The policies proposed in this book are specifically designed to address the effects of life-expectancy increases. Thus, as a starting point, it is important to understand something about those increases. In the past 50 years, the increase in life expectancy at older ages has been considerable. Life expectancy at age 65 rose from 14.4 years in 1960 to 18.5 years in 2006, an increase of four years (Arias et al. 2008). This change has considerably increased the cost of providing pensions.

Yet the full story is more complex than simply one of widespread increases in life expectancy. The United States has a diverse population in terms of both income and ethnicity. The disparities in life expectancy across some groups are large. When groups are broken into detailed categories by race, gender, and geographical area, the gap between the highest and lowest life expectancies at birth for race-county combinations in the United States is more than 35 years (Murray et al. 2006). Furthermore, differences in life expectancy across demographic groups have increased in recent decades (Freedman et al. 2004).<sup>1</sup> For example, disparity in life expectancy between whites and blacks is growing. (See Chapter 2.)

Having important distributional (and thus social and political) consequences, the increase in longevity for older persons has occurred mostly among those in the top half of the earnings distribution. A male in the top half of the earnings distribution who reached age 60 in 1972 could expect to live 1.2 years longer than one in the bottom half. By 2001, the gap for 60-year-olds had grown to 5.8 years (Waldron 2007). This large difference has major implications for public policy dealing with the effects of longer life expectancy.

It is also important to note, however, that life expectancy improved for both earnings groups. Measuring life expectancy from birth for the male cohort born in 1912, researchers found that, among those in the bottom half of the earnings distribution, 50 percent were still alive at age 77. Those in the top half of the earnings distribution reached age 79 before their survival rate fell to 50 percent. By comparison, for the male cohort born in 1941, the ages at which mortality reached 50 percent improved to 80 and 86, respectively. Thus, this measure of life expectancy lengthened by three years for males in the bottom half and by seven years for those in the top half.

The policy debate over the equity effects of raising the early retirement age for Social Security or other changes based on improvements in life expectancy is determined to a large extent by the choice of the baseline comparison. Often in policy issues relating to equity, the choice of the baseline comparison is key. If the baseline comparison is the present, then the differences in life expectancy by income are key. If the baseline comparison is the past, then the improvement in life expectancy by all groups is important. In that case, the increase in life expectancy for all groups can be viewed as justifying raising the early

retirement age, which would leave no group worse off compared to the past. That is the perspective taken in this book.

### **Other Demographic Changes**

As well as changes in life expectancy, changes in retirement age and in the age at which people enter the labor force also affect Social Security and pension financing. In 1940, when Social Security first paid retirement benefits and when the earliest age at which those benefits could be collected was 65, workers reaching age 65 lived, on average, for another 13 years. Many workers began work at age 18, immediately after high school. These workers could work for as long as 47 years before reaching the normal retirement age of 65. For a full-career worker, a pension plan could anticipate the amount of contributions needed to finance 13 years in retirement and could make these contributions over a 47-year period. The number of years a full-career worker spent in retirement was thus between one-fourth and one-third of the number of years that worker had spent in the labor force.

Now most workers claim Social Security retirement benefits at age 62 rather than at age 65. Many entered the labor force at a later age than in the past, often at age 21 or even older, rather than at age 18. This leaves about 40 years of work possible before an expected retirement at age 62, with a remaining life expectancy of approximately 20 years. Thus, a pension plan can anticipate about 40 years of contributions for a full-career worker to finance about 20 years of retirement. The number of years spent in retirement is about half of the number of years spent in the labor force, up from less than one-third in 1940 (American Academy of Actuaries 2006). This book considers both changes in retirement age (see, in particular, Chapter 4) and changes in life expectancy.

### **The Cost of Increased Longevity**

What does increased longevity cost? Projected longevity increases are a major cause of the projected funding shortfalls for Social Security. The Congressional Budget Office (CBO) has estimated the cost savings if benefits were indexed for life expectancy, a proposal considered in this book. With that change, increases in life expectancy would reduce annual benefits received by future retirees. That one change would eliminate 43 percent of Social Security's long-term deficit (CBO 2005).

In the long term, increases in longevity are the main aspect of demographic change that increases Social Security's costs. A study by the Social Security Administration indicates that if a baseline of 2008 is chosen, increases in life expectancy after that date have little effect on program costs through changes in the dependency ratio for the first 20 years, but after 2030 they are projected to account for all the changes in the dependency ratio (Goss 2010). The dependency ratio is a key parameter in determining the costs of providing Social Security benefits. Thus, in the long term, increases in life expectancy are key.

A related issue to increasing life expectancy is population aging. Populations age when people live longer and when fertility decreases, which results in there being fewer young people in the population. The aging of the baby boom population bulge also contributes to population aging. This book focuses specifically on increased life expectancy in terms of its effects and the possible policy responses, and only deals with population aging and the population bulge peripherally.

While the future course of life expectancy is unknown, the Social Security Administration, other government agencies, and most demographers predict that it will continue to increase. One reason to expect that life expectancy at older ages will continue increasing is that the United States lags behind a number of countries in this regard. In 2005, life expectancies at age 65 for women and for men in this country were 19.0 and 17.0 years. In that year, the figures in France were 19.8 and 18.2. In Japan, they were 23.4 and 18.5. Compared to U.S. figures, the figures were higher for women in at least 17 countries and were higher for men in at least 13 countries (National Center for Health Statistics 2009a).

## **THIS BOOK**

The remainder of the book is organized into four parts, the first three of which all discuss various policy responses to increased longevity. The first of these, Part 1, deals with issues relating to the labor market for older workers. It considers changes in the health of older workers and changes in job requirements by employers, two issues affecting whether older workers could work longer. It argues that the evidence

supports the ability of most people to extend their working lives, making feasible a policy that would encourage later retirement. The widespread strikes in France when this was proposed in 2010 indicate that this can be an unpopular proposal.

Part 2 of the book considers how Social Security policy is affected by increasing life expectancy. Its first chapter examines automatic adjustment mechanisms that could be adopted to restore and maintain Social Security solvency, including raising the early retirement age. Social Security currently adjusts benefits for postponed benefit receipt so that, for a person with average actuarial life expectancy, the present expected value of benefits is roughly equal at age 62 or 63, thus providing neither an incentive nor a disincentive to postpone retirement. For people expecting to live longer than the actuarial average, there is an incentive to postpone retirement.<sup>2</sup>

The question could be asked, “Why raise the Social Security early retirement age, given that Social Security provides incentives for some workers to postpone retirement already?” Social Security provides incentives for workers with longer-than-average life expectancy to postpone retirement because the increased benefits they receive are for more than the average number of years. However, the actuarial adjustment for postponed receipt of benefits is insufficient to provide such incentives to people with shorter-than-average life expectancy. In any case, regardless of the incentives, many people are shortsighted and take benefits at age 62, the earliest age at which benefits are available, even though they would be better off financially if they postponed benefit receipt.

In discussions about policy reform of Social Security, participants often find the issue of raising the retirement age confusing. Often, when those discussions refer to the Social Security retirement age, they are referring to the normal retirement age, which is a technical term for the age at which a person can receive what are considered to be full benefits. For people currently aged 62, that age is 66, but changes already enacted into law raise it to age 67 for people born in 1960 and later. When this book refers to raising the retirement age for Social Security, it is referring to the early retirement age, which is 62, but which for more than 20 years at the start of Social Security was 65. The reason the issue of raising the retirement age can be misleading is that raising the normal retirement age would have no effect on the earliest age at which

people can receive Social Security benefits, which continues to be 62. It is equivalent, instead, to a benefit cut.

Retirement income policy is fundamentally about making hard choices. This holds true for both individuals and national policymakers. An alternative to workers working longer is to increase workers' savings and worker and employer contributions to Social Security and pension funds to pay for retirements that are being lengthened by increasing life expectancy. Whatever changes are made in public policy, that option with respect to personal savings remains for individuals: those who wish to retire early can plan to do so by raising their savings. That said, many individuals find retirement planning, with its long time frame, difficult to do.

In the public arena, politicians and the general public face the possible choice, among others, between raising the Social Security payroll tax and raising the Social Security early retirement age, so that benefits currently receivable at age 62 would instead be received at age 63. Any change in the early retirement age would presumably take effect many years in the future, with a phase-in period starting at that point. Given the widespread antipathy toward raising Social Security contributions, and the improvements in the ability of people to work in their early sixties, this book presents the case for raising the early retirement age.

The section on Social Security also contains a proposal for a new benefit, called longevity insurance, that would be payable starting at age 82. It focuses on two vulnerable groups: first, workers who retire at age 62 in poor health, with poor work prospects and little in retirement resources other than Social Security; and second, retirees in their eighties who have spent down their non-Social Security assets and rely primarily on Social Security benefits.

Part 3 of the book looks at private pension policy as it is affected by increasing life expectancy. It discusses issues for 401(k) plans and for defined benefit plans. The most common type of pension plan in the United States is the 401(k) plan, named after the section of the tax code that enabled it. It is a defined contribution plan, where the worker's benefit is based on the amount accumulated in a pension account. Ways to encourage more people to annuitize their 401(k) plan account balances are discussed.

The chapter on defined benefit plans proposes a new type of defined benefit plan, called a life expectancy-indexed defined benefit plan.

Defined benefit plans are traditional pension plans, where the worker's benefit at retirement is typically based on a benefit formula that incorporates years of work and some measure of the worker's salary. A life expectancy-indexed defined benefit plan would incorporate a feature of defined contribution plans that provide annuities. It would "de-risk" defined benefit plans of most of the longevity risk that plan sponsors bear currently, which could encourage employers to provide defined benefit plans.

The book's fourth and final part is its conclusion, which consists of a chapter on policy recommendations. Yet public policy books shouldn't be read like novels: readers need not wait for the suspense to be resolved at the end. While this book first presents the evidence concerning the ability of many people to extend their working lives and the evidence concerning other policy prescriptions, readers who care more about the policy prescriptions and less about the development of the material supporting them should read the last chapter first. The next several pages provide a brief overview of some of the major policy recommendations.

## **FIVE POLICY RECOMMENDATIONS**

While the final chapter provides a more detailed summary and justification of the policy recommendations I make, this section provides an overview of five of the major recommendations (Table 1.1). Three of the recommendations involve Social Security. While changes concerning Social Security that involve retrenchment are not popular, these changes are recommended within the context of recognizing that some changes are needed to restore solvency.

### **1) Index Social Security Benefits for Life Expectancy**

First, I recommend that Social Security benefits be indexed for life expectancy, so that increases in life expectancy would not cause an increase in the lifetime value of pension benefits. This type of indexation has been adopted by Sweden for its social security program.<sup>3</sup> From a lifetime perspective, this change is not a benefit cut, but it does result in lower annual benefits than otherwise.

**Table 1.1 Overview of Major Policy Recommendations**

Policy area	Policy	Goal
1) Social Security	Life-expectancy indexing of benefits	Help restore solvency
2) Social Security	Raise early retirement age from 62 to 63	Raise benefit level to offset benefit cuts
3) Social Security	Longevity insurance benefit payable at age 82	Provide better targeting of benefits; offset benefit cuts
4) 401(k) plans	Require that annuities be offered when a defined benefit plan is not also offered	Encourage annuitization of 401(k) plans
5) Defined benefit plans	Life expectancy–indexed DB plan	Encourage provision of defined benefit plans

SOURCE: Author's recommendations.

With this type of indexation, every year, for each new retirement cohort, benefits would be slightly adjusted downward to take into account the effect of increased life expectancy on the lifetime value of benefits. The adjustment would occur for each cohort only once; thus, benefits received at retirement would face no further adjustments for continued increases in life expectancy during the retirement period.

According to calculations done by the CBO (2005), this change would reduce the present value of the 75-year Social Security deficit by 0.5 percent of payroll, a reduction in the present value of the deficit, in the CBO's calculations, of 42 percent. The Congressional Budget Office estimates that with this change the date of Social Security insolvency would be 2059, which is sufficiently far into the future that no further cost-saving changes would need to be made for at least a decade. This type of indexation results in a reduced replacement rate over time, an issue addressed by the following proposal.

## **2) Raise the Early Retirement Age**

Second, I recommend that, using a long delay and phase-in period, the Social Security early retirement age be raised from 62 to 63. This change is consistent with policy in Germany, the United Kingdom, Switzerland, and a number of other countries that have early retirement

ages of 63 or higher (Turner 2007). An early retirement age of 63 is two years younger than what the early retirement age for Social Security was when President Franklin Roosevelt signed the Social Security Act and benefits were first paid in 1940. Life expectancy has increased for all demographic groups since 1940.

This change could be accomplished in one of two ways. First, it could be done so that persons retiring at age 63 would receive the advantage of the actuarial adjustment currently provided for postponing benefit receipt from age 62 to 63. This approach would raise the level of benefits for persons who previously would have retired at age 62, by providing an additional boost in their benefits if they worked the extra year. This approach would not affect Social Security's long-run finances. Alternatively, the second approach would provide, at age 63, benefits currently receivable at age 62. That approach does not cut annual benefits for those who were going to retire at age 62, but it does cut lifetime benefits and would result in cost savings.

### **3) Add a Longevity Insurance Benefit**

My third recommendation for Social Security is to add a new type of benefit called a longevity insurance benefit. Longevity insurance would be a type of social insurance providing benefits to qualifying persons at an advanced age—initially set at age 82, but automatically increased to take into account future increases in life expectancy.

As retirees age, they face an increased risk of poverty as they spend down their non-Social Security assets. A longevity insurance benefit would be paid by Social Security starting at age 82 for people who had at least 20 years of covered earnings and were receiving Social Security benefits below a fixed level. Payment would not require an application or a means test; it would occur automatically. It would be a targeted, cost-effective way of addressing poverty at advanced old age. Longevity insurance could be included in a reform package to restore Social Security solvency that contained benefit cuts, so that it would prevent benefit cuts from increasing poverty rates at advanced older ages. It would not have the problem of low take-up rate, which Supplemental Security Income (SSI) has, because eligible retirees would automatically receive it.

#### **4) Require 401(k) Plans to Offer Annuities, if They Are the Sole Plans**

A fourth recommendation I make is to require that 401(k) plans offer annuities when those plans are provided by an employer that does not also provide a defined benefit plan meeting minimum standards of generosity. Initially, most 401(k) plans were supplemental plans provided by employers who also provided defined benefit plans. That is no longer the case, but they still are regulated to a large extent as if they were supplemental plans. This requirement would treat 401(k) plans that are the primary plan as pension plans rather than as savings plans, as they are currently treated.

#### **5) Permit Life Expectancy–Indexed Defined Benefit Plans**

Because of the different types of risks that defined benefit and defined contribution plans impose on participants, a pension system would be more diversified if it provided both defined benefit and defined contribution plans to most workers. In order to encourage employer provision of defined benefit plans, my fifth recommendation is that pension law be amended to permit a new type of defined benefit (DB) plan, called a life expectancy–indexed DB plan. This plan would allow more efficient bearing of life expectancy risk than is currently permitted in defined benefit plans, which may encourage employers to provide such a plan.

With a life expectancy–indexed DB plan, at retirement the generosity of the plan would be adjusted to take into account improvements in life expectancy, which would be analogous to annuitizing a defined contribution plan account using current life expectancy, or to the changes proposed for Social Security. Thus, cohort life expectancy risk would be shifted to workers, who can bear it more easily than plan sponsors because the workers are the prime beneficiaries of the increase in life expectancy. This recommendation for defined benefit plans is equivalent to Recommendation 1 for Social Security.

## CONCLUSIONS

The premise of the book is that public policy should recognize longevity policy as a distinct policy area. Policy should be developed that is directly related to the effects of increasing life expectancy. Rather than separately treating the issues raised by life expectancy concerning Social Security, pensions, and work at older ages, a unified approach should be developed that recognizes their interrelationship. A unified approach may facilitate the needed changes in each of the areas. Dealing with only one area may be more difficult and less effective than dealing with all the areas at the same time. Together, the policies recommended in this book would encourage work at older ages, move Social Security toward solvency, provide better targeting of Social Security benefits, increase annuitization of 401(k) accounts, and encourage employers to provide defined benefit plans.

### Notes

1. Healthy life expectancy, which combines morbidity and mortality, is an indicator of expected years of life lived in full health without disease or disability.
2. Actuarial life expectancy is based solely on a person's age, and sometimes gender. Some people have family histories where they expect to live substantially longer than their actuarial life expectancy.
3. In this book, I follow the practice of uppercasing "Social Security" when referring to the U.S. system, and of lowercasing the term when referring to social security systems in other countries or to social security systems generally.